

REMEDIES

Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures

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The derivative suit, that perennial target of the commentators' blandishments and ire, is once again a center of lively scholarly attention. Its popularity today is attributable to an unusually high number of recent, significant derivative-suit decisions¹ as well as to the thoughtful and provocative proposals of the American Law Institute.² This Article does not examine specific problems of derivative-suit procedure, but addresses a more indefinite, but fundamental question: what purpose lies at the heart of the corporate cause of action against fiduciaries? Resolution of this question is frequently clouded by ascribing to the derivative suit both deterrent and compensatory purposes and by choosing between them when matters of derivative-suit procedure cause them to conflict. Others who prefer the freedom of the market have sought the answer to this question by ignoring these labels, viewing them as excess baggage on the journey through agency or port-

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1. See, e.g., *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980) (holding corporate directors incompetent to compromise derivative claims because of a conflict of interest), *cert. denied*, 450 U. S. 1029 (1981); *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984) (denying standing to continue derivative suit to plaintiff who ceased to be shareholder); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (requiring court to consider directors' good faith, independence, and bases before ruling on its motion to dismiss).

2. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS ch. VII (Council Draft No. 3, 1983) [hereinafter cited as CORPORATE GOVERNANCE].

folio theory. Because the debate on the useful purpose, if any, served by a corporation's recovery for its fiduciaries' wrongdoing covers all of these perspectives, this Article engages each in its quest to express a view of the derivative suit's grand mission, even if that mission is to retire. The final section of this Article offers a criticism of the Reporters' attempt to ascribe too many purposes to the derivative suit.

I. Why All the Bother?

The derivative suit's usual *raison d'être* is the need to redress violations of a corporation's rights that other mechanisms do not remedy.³ However, this view of the derivative suit — envisioning both the necessity and the inevitability of vindicating a corporation's rights — is troubling nonetheless because litigation is costly and plaintiffs initiate representative actions in a somewhat fortuitous manner. Many have recognized that the market for stocks and managers provides a more systematic and economical regulator. These virtues of the market have caused many commentators to begin and to conclude their consideration of how to control management misbehavior with market-based solutions. Were this view correct, consideration of the derivative suit's other purposes — compensation and deterrence — would become superfluous to justifying the suit on any ground. The belief that market forces constitute a more powerful obstacle to managerial misbehavior rests on several interrelated but distinct theories. The theory advanced to support a market-based solution often depends upon the type of managerial misbehavior.

A. Agency Theory

With the separation of management from ownership in public corporations, managers who hold a small ownership interest are thereby subject to forces that drive them naturally to maximize their own utilities rather than the firm's wealth.⁴ Simply illustrated, the manager who owns 0.5% of his company's stock gains only \$50 by locating and directing a new business opportunity worth \$10,000 to the company. However, appropriating the advantage exclusively to himself increases his personal wealth by \$9,950 above that received if he so fulfills his fiduciary obligation. Corporations respond to managers' tendency to misbehave with a combination of contracting arrangements, monitoring, and signaling.⁵ These devices not only curb managers' more extreme tendencies, but also reduce the firms's cost of capital and increase its value.

3. This view was first recognized in the United States in *Hawes v. Oakland*, 104 U.S. 450, 453-61 (1881).

4. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 345-50 (1976) (offering a rigorous model of corporate managers' natural drive to misbehave).

5. See *infra* notes 8-11 and accompanying text for a discussion of signaling and monitoring.

Information asymmetries accompany managerial misconduct: managers know the frequency and amount of harm caused by their misconduct, whereas outside investors do not. This asymmetry poses serious constraints for contractual arrangements intended to reduce a manager's incentive to misbehave, for example, by adding incentive compensation tied to improvements in a firm's profits. Managers may refuse to trade gains derived from misbehavior for incentive compensation if the levels of incentive compensation are unrealistic, if they can both misbehave and satisfy the incentive compensation level, or if incentive compensation provides fewer rewards than continued misbehavior. Likewise, investors might reject incentive compensation arrangements that increase managers' overall compensation without a satisfactory reduction of their agency costs. Consequently, managers whose compensation, in part, depends on changes in their firm's performance may choose not to amend their errant ways by foregoing private gain at the firm's expense, at least when the market is unable to detect their abuse. Moreover, rational investors would not pay additional compensation for a benefit attributable merely to the fortuity of the market's overall improvement and not to management's improved behavior.⁶ The problem of informational asymmetry exacerbates these impasses because markets that cannot discern an individual firm's respective agency costs instead discount the value of each firm by the average estimated agency cost of all firms.⁷

Theorists suggest that market signaling resolves this impasse; managers who truly do not wish to misbehave emit a message distinguishing their firm from firms whose managers misbehave.⁸ Signaling addresses the information asymmetry problem so that investors will not discount the securities of the non-misbehaving companies by the average risk prevalent in the industry.⁹ In addition to signaling, a firm may also reduce its agency costs by using monitoring devices designed to police management. Monitoring, however, is efficient only to the extent its marginal benefits ex-

6. Akerloff, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 497 (1970) (establishing relationship between product quality and buyer uncertainty).

7. A significant portion of any firm's return is attributable to forces which, at least in the short-term, are beyond its managers' control and result from wholly external influences. An individual security's movement in the market explains approximately 30% to 50% of its return; industry-wide influences account for another 10% to 15%. See generally J. COX, FINANCIAL INFORMATION, ACCOUNTING AND THE LAW 170-76 (1980).

8. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory* in ISSUES IN FINANCIAL REGULATION 177 (Edwards ed. 1979); M. SPENCE, MARKET SIGNALING 88-95 (1974).

9. Akerloff, *supra* note 6, at 489.

ceed its marginal cost.¹⁰ Because monitoring contains diminishing marginal benefits, monitoring generally prevents only the more extreme managerial departures. Independent accountants and directors are popular, but not wholly successful monitoring devices.¹¹

Rather than serving as a separate basis for retiring the derivative suit, agency theory highlights the function of externally imposed fiduciary duties. There is nothing inconsistent between investors "contracting" with managers to establish mutually acceptable parameters of discretionary behavior while the law imposes parameters through fiduciary obligations. Indeed, private contracting alone would be both inefficient and subject to inherent free-riding; externally established "rules of the road" avoid these problems.¹² Hence, acceptance of the theoretical foundations of agency theory supports the vitality of derivative suits. Agency theory may produce a reexamination of the precise limits on managerial discretion that rational investors believe further their best interests. Examples of these limits are discussed later.

Furthermore, contracting, monitoring, and signaling are efficient only when their marginal costs do not exceed the marginal benefits derived. Thus, some level of misbehavior and its consequent harm will occur even in the presence of elaborate monitoring devices because it is not economical to prevent all managerial misconduct. However, the derivative suit, clothed with carefully tailored procedures, can constitute an economical device to redress and deter misbehavior significant enough to make the suit worthwhile, but not so great as to warrant intracorporate mechanisms of contracting, signaling, and monitoring.

B. Portfolio Theory

The important teaching of portfolio theory explains the beneficial effects of holding an efficient portfolio. An efficient portfolio requires investments in a large number of firms in different industries. A fully diversified investor assumes the risk of the market as a whole, generally referred to as systematic risk, and avoids the risk specific to each individual firm.¹³ The preceding discussion of agency costs¹⁴ suggested that the average agency cost for all firms

10. Jensen & Meckling, *supra* note 4, at 324-25.

11. Auditing, which appears to have been the more widely used monitoring device, preceded the wide adoption of "outside" boards of directors by several decades. See Watts & Zimmerman, *Agency Problems, Auditors, and the Theory of the Firm: Some Evidence*, 26 J.L. & ECON. 613, 631-32 (1983).

12. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 754 (1978); Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 49 (1982).

13. For a very understandable description of the twin aspects of diversification and systematic risk and the relative size of the portfolio required to achieve each, see FASB, TENTATIVE CONCLUSIONS ON OBJECTIVES OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES 65-77 (1976). The more mathematically inclined reader may prefer W. F. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* (1970).

14. See *infra* notes 4-11 and accompanying notes 98-128.

constitutes one source of systematic risk reflected in any firm's cost of capital. So viewed, an important contribution of derivative suits is their potential impact upon the level of systematic risk by deterring managerial misbehavior and not simply compensating the specific firm whose managers have misbehaved. Consequently, management misbehavior that affects a specific firm, arguably, does not harm investors holding an efficient portfolio because the misconduct's impact is offset by the randomness of firm-specific gains and losses, which sum to zero.¹⁵ Therefore, under this view, resources expended to redress a corporation's injury are not efficiently employed because they consume rather than increase wealth. On the other hand, if derivative suits have the collateral effect of widely mitigating agency costs so that the threat of suit effectively reduces systematic risk, they are economically justified. With this reduction, the investor can make sharper comparisons between investments, including risk-free assets and non-managed risky assets.

The commentary accompanying the ALI's proposals justifies strengthening the derivative suit, even if no net gain accrues to a specific firm, because of the social benefits that flow from deterrence as well as the enforcement of regulatory provisions.¹⁶ In addition, a lower systematic risk can, and presumably does, result from suits that leave corporations better off than before the suit. Therefore, portfolio theory strongly supports the belief that derivative suits yield benefits, notwithstanding small recoveries or even occasionally net losses to individual corporations provided that the benefits of deterrence generally exceed an individual derivative suit's cost to a corporation.¹⁷

Other scholars have misapplied portfolio theory to reach perverse limits on substantive law. For example, Professors Easterbrook and Fischel reason that in certain control-person transactions derivative suits are both superfluous and a vehicle for unjust enrichment.¹⁸ They analyze the corporate freeze-out of minority shareholders,¹⁹ reasoning that these transactions do not injure shareholders who hold an efficient portfolio. This conclusion is startling, even to a well-diversified investor. Consider an inves-

15. See, e.g., Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 711-14 (1982); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1268 (1982); Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1242-43 (1979).

16. CORPORATE GOVERNANCE, *supra* note 2, at 232-36.

17. The sum of the monetary recovery plus the systematic benefits derived must therefore exceed the derivative suit's cost to prosecute.

18. Easterbrook & Fischel, *supra* note 15, at 723-31; cf. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RESEARCH J. 875, 887.

19. Easterbrook & Fischel, *supra* note 15, at 723-31.

tor who places one percent of his wealth in each of a hundred companies, one of which, company A, owns ninety percent of company B, which is also in the investor's portfolio. If A freezes out the B shareholders so that this investor receives only \$5,000 for shares worth \$8,000 before notice of the freeze-out, the investor will recoup only \$300 of this loss through his one percent ownership in company A.²⁰ To avoid losses, the investor's ownership in the parent company must not equal his investment in the firm that disappeared, but must always be proportionate to his percentage ownership of all the minority B shares,²¹ or ten percent in the illustration. The portfolio strategy suggested by Professors Easterbrook and Fischel requires disproportional investing based upon an investor's successful *ex ante* identification of firms that will be taken over by freeze-outs and the firms that will become the parent companies.²² Making such choices²³ becomes even more problematic because normally the misbehaving corporation will be much larger than its abused subsidiary. Thus, the requisite percentage ownership will likely entail a larger investment in the parent than a mere percentage comparison might suggest. Some have pointed out that in certain situations the parent corporation's shares do not trade publicly, making proportional investment in the defendant impossible.²⁴ Finally, one can expect to benefit from Professors Easterbrook and Fischel's counsel that the gains garnered by stock ownership in another corporation offset the

20. The total loss to the minority shareholders who own 10% of Company B is \$30,000, the gain that Company A reaps by its condemnation of the Company A shares at an unfair price.

21. The amount that the parent gains in an unfair freeze-out can be expressed as:

$$G = X[(1-p)V]$$

where

G = dollar amount of freeze-out gain

X = percentage of the minority's value in firm misappropriated to parent in freeze-out

p = percentage of stock owned by parent

V = value of the firm

To express the freeze-out's effects, g, in terms of a single stockholder, the stockholder's percentage of ownership of the firm, y, must be reflected as a percentage of his share in the minority's interest in the firm, $\frac{y}{1-p}$, so that

$$g = X[(1-p)V]\frac{y}{1-p}$$

It can therefore be seen that $\frac{y}{1-p}G = g$

In other words, an individual shareholder's loss, g, can be recouped by sharing in the parent's gain only if he owns the same proportion of the parent's stock as his proportionate ownership of the frozen out majority's interests.

22. For an investor to protect himself by his own diversification strategy, he must identify the partners to the unannounced freeze-out so that he can estimate his precise proportion of the minority interest in the acquired company and invest that amount in its acquirer.

23. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEV. ST. L. REV. 203, 218 (1981).

24. See Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1073 (1983), for a far-ranging response to scholars, such as Professors Easterbrook and Fischel, who favor disproportionate treatment of minority shareholders.

losses suffered only when the investor's portfolio includes an equal number of gain and loss securities. Because few companies will benefit from control-party transactions, investors seeking an efficient portfolio will probably find their portfolios over represented by one or the other. Because investors cannot detect this feature in advance, the overall effect will be a greater systematic risk, not lower risk, as Professors Easterbrook and Fischel suggest.

Analysis of the inherent weaknesses of a portfolio strategy to unfair freeze-outs illustrates the near impossibility of achieving a properly balanced portfolio of stocks to assure protection. The analysis also demonstrates the many practical considerations that severely limit the availability of a portfolio strategy. Freeze-out transactions, however, are not central to the present discussion because derivative suit procedures do not address misconduct that involves disproportionate sharing between the control person and minority shareholders, as occurs in unfair freeze-outs. Nevertheless, the freeze-out illustration sharpens the focus of the portfolio strategy's ability to protect investors against corporate misconduct because that illustration is less complex than the misconduct alleged in most derivative actions.

Control-person misconduct, subject to a derivative suit, involves proportional harm across all the firm's shareholders and usually arises from some form of overreaching by the control person.²⁵ When shareholders share the harm to the subsidiary proportionally, an eighty percent corporate stockholder suffers eighty percent of the loss and its shareholders garner one hundred percent of the gain. A one percent stockholder in each corporation will occupy the same position after the overreaching transaction as he did before its occurrence. Although in this type of case a portfolio strategy is theoretically possible, as a practical matter an investor holding a one percent interest will still be frustrated in his attempts to seek protection through an efficient portfolio. He will encounter the same limitations that erode the strategy's protections in the freeze-out situation. Not only is the misbehaving stockholder likely to be larger than the subsidiary, requiring a larger absolute investment to assure proportionate ownership, but the subsidiary may not trade publicly. Moreover, the strategy works only when the portfolio contains a balance between "gainers" and "losers." This balance may evade the investor because the misconduct that investment in "gainers" seeks to offset occurs

25. See, e.g., *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. 1970) (derivative action exists where mismanagement causes proportionate injury to stockholders); *Jones v. H. F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (derivative action exists where harm to corporation is proportional among all shareholders).

so infrequently that the portfolio may not “even out” with the selection of a large number of portfolio companies. Also, the portfolio solution does no good in the vast majority of cases that involve misconduct by managers because there is no entity in which an individual may invest to recover what the manager misappropriated. Finally, portfolio theory provides no guidance in deciding what rules shareholders wish *ex ante* to regulate managerial misconduct when all the evidence indicates that many investors do not own efficient portfolios.²⁶

Even if the efficient portfolio strategy coped with managerial misconduct, invoking it as grounds for retiring the derivative suit is tantamount to decreeing that the law should penalize investors who fail to adopt this “optimal” investment strategy. Worse yet, advocates deliver this decree without amply describing the failings of the status quo. Although portfolio theory has contributed immeasurably to investment strategy and securities market research, its usefulness in corporate law is more modest than that envisioned by Professors Easterbrook and Fischel. With an understanding of the sources of systematic and firm-specific risk that comes from portfolio theory, one can see the benefits, rather than the weaknesses, of the derivative suit. As seen earlier,²⁷ managerial misconduct contributes to systematic risk and, therefore, to the cost of each firm’s capital. Reduction in managerial misconduct through the deterrence force of derivative suits can therefore have a positive effect on an overall allocation of resources.²⁸ The role of portfolio theory is not that of an insurance policy for managerial misconduct, but rather a means to understand the relationship between misconduct, the derivative suit, and the cost of capital.

C. *The Market for Control*

The final market-based solution to corporate misconduct is the displacement of management, most popularly through the hostile takeover. This response to managerial misbehavior relies on an unwavering faith in the efficiency of securities markets to price all publicly traded securities to reflect the economic effect of publicly available information.²⁹ A management that publicizes, however

26. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 29-30 (1982).

27. See *supra* notes 4-7 and accompanying text.

28. See, e.g., Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980) (a restrained view of portfolio theory’s use to consider the regulation of insider trading).

29. There appears to be an important gulf between what empirical studies of market efficiency actually disclose about the operation of securities markets and what most legal commentators attribute to these findings. The early studies of market efficiency, relied upon by legal commentators, are completely described in Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); and Kaplan & Roll, *Investor Evaluation of Accounting Information: Some Empirical Evidence*, 45 J. BUS. 225 (1972). A thoughtful analysis by Professor Beaver, who has played a significant role in the area, shows that scholars have misinterpreted these empirical studies. Beaver, *Market Efficiency*, 56 ACCT. REV. 23 (1981). The particular

obliquely, its departure from maximizing the firm's value, or seeks to hide its agency costs through arcane accounting chicanery, will find that its securities' prices reflect the economic significance of its misdeeds.³⁰ With shares heavily discounted from the price they could command under management with little or no agency cost, the firm becomes the target of those whose managers have a lower proclivity to mismanage or misbehave.³¹

Challenges to managerial misbehavior, as with either agency or portfolio theory, may come from within the existing set of shareholders by a proxy contest to remove management, but most frequently result from an outsider's hostile tender offer. The market-for-control argument is slightly more persuasive in arguing for changes in the rules governing corporate takeovers than it is for the proposition that derivative suits be curtailed.³² The most significant weakness in the market-for-control solution as a deterrent to managerial misbehavior lies in its ineffectiveness against so-called "one shot" breaches of fiduciary duty by managers, the most frequent object of the derivative suit.³³ Directors and of-

glaring fault in the analysis of market response to corporate wrongdoing is the assumption that *all* securities are efficiently priced so that evidence of corporate wrongdoing will surely cause the affected firm's shares to be priced low in securities markets. See authorities cited *infra* note 31. In fact, market efficiency studies are quite generalized in their findings, applying only to the security price behavior of a portfolio of stocks and not to the individual securities. These findings are limited to stocks of large publicly traded firms for which reliable research data bases can most easily be assembled. Indeed, there is reason to expect that for smaller firms, or for firms where the wrongdoing is costly to discover, that markets are inefficient. See Grossman & Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 405 (1980).

30. See, e.g., Beaver, *What Should Be the FASB's Objectives?*, J. ACCT. Aug. 1973, at 49, 50-51; Gonedes, *Efficient Capital Markets and External Accounting*, 47 ACCT. REV. 11, 16 (1972).

31. The most extreme proponents of this view are Professors Easterbrook and Fischel who have applied this refrain to a host of corporate ills. See, e.g., Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (shareholder well-being decreases when corporate management engages in defenses to tender offers); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) (responds to Bebchuk's and Gilson's criticism of Easterbrook and Fischel's entire article) [hereinafter cited as Easterbrook & Fischel, *Auctions*]; Easterbrook & Fischel, *supra* note 15; Fischel, *supra* note 15; Fischel, *Efficient Capital Market Theory, the Market for Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978) (without regulating barriers the efficiency of the market for corporate control would improve). The great credit for this line of analysis, however, can be given to Manne, *Mergers And The Market For Corporate Control*, 73 J. POL. ECON. 110 (1965). Manne apparently assumes that investors may not be able to discern the firm's poor performance because competing firms in the same industry may have better insight to poorly performing companies and should therefore have greater latitude under the antitrust laws to capture the gains of managerial ineptitude through merger. *Id.* at 118.

32. See Bebchuk, *supra* note 26; Easterbrook & Fischel, *Auctions*, *supra* note 31, at 21; Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

33. See, e.g., Easterbrook & Fischel, *supra* note 15, at 701 (market mechanisms

ficers who have a chance to achieve unprecedented wealth through a single misdeed have less concern for their continued association with the firm which provided them with that once-in-a-lifetime opportunity. Therefore, the takeover is generally considered more effective in displacing managers who have systematically underemployed or misemployed the firm's resources. Because of the business judgment rule's broad protections for management decision making, the derivative suit provides only a moribund response to management misconduct regarding use of the firm's resources.³⁴ The conclusion, therefore, emerges that the markets for control and management both function best in those situations in which the derivative suit does not apply: ordinary decision making.³⁵ Moreover, corporate takeovers are extremely expensive with costs quickly reaching several million dollars should the incumbents decide to resist.³⁶ The magnitude of a manager's misdeed, therefore, must be extremely high before the impact influences the firm's stock prices or attracts a bid for control. Hence, with such high transaction costs, not to mention the costs associated with the detection of the manager's wrongdoing, the market for control will not effectively control all management misbehavior.³⁷ Even when the magnitude of managerial misconduct attracts a bid for control, significant legal questions arise whether that suitor, once it installs its own management, can recoup from the former managers the fruits of their earlier misdeeds. The new managers must first overcome the concern that recovery does not constitute a form of unjust enrichment.³⁸ Moreover, they may find that the illegal gains have been substantially dissipated or otherwise removed, making a judgment an empty victory. Consequently, wrongdoers remain rewarded for their misdeed, and suitors cannot depend upon recoupment from the wrongdoers as a source of the acquisition's gain, a matter of greater import in the case of one-shot wrongdoing.

For all of these reasons, even the most fervent proponents of market-based solutions believe the derivative suit has a role to play in redressing and deterring managerial misbehavior.³⁹ How-

may be inadequate to deal with one-time defalcations); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 273 (1977).

34. For example, recent cases that have questioned director judgments have all been single-transaction judgments which are tainted by fraud or self-dealing. See *Joy v. North*, 692 F.2d 880, 894-95 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); *Francis v. United Jersey Bank*, 87 N.J. 15, 44-45, 432 A.2d 814, 829 (1981).

35. See *infra* note 39 and accompanying text.

36. Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 239 (1983) (estimates that a resisted tender offer can raise the transaction costs quickly to \$15 million).

37. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 753 (1978).

38. See *infra* text accompanying notes 98-128.

39. See Easterbrook & Fischel, *supra* note 15, at 701-02; Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 938-39 (1983); Winter, *supra* note 33, at 273. Each of these authors would limit the scope of derivative suits to "one-shot" abusive practices which, as seen earlier, have been essentially the focus of the derivative suit, rather than their perceived fear of

ever, concerns about whether suits in particular instances stimulate optimal incentives or result in unjust enrichment remain in dispute. The following sections examine each of these concerns.

II. Limitations Bounded by Incentives to Embrace Risk and Monitor Management

There has developed in the case law and commentary a growing sensitivity to the need to balance harm to the corporation arising from the defendant's conduct with the impact of the recovery on the party's incentives to perform a defined, socially useful function. The concern has arisen, primarily, in two settings.

The first variation concerns whether a corporate recovery may conflict with the shareholders' responsibility to monitor management closely to discourage its misbehavior. An affirmative answer to this question imposes an important constraint on the scope of the derivative suit's utility, based on the circumstances, but not necessarily on the type of substantive wrong committed by management.

The second variant considers the proposition that imposing liability may discourage entrepreneurial risk-taking and adversely affect profit maximization. The suggestion here is that the substantive duties of management are at times misdirected, which in turn reduces the scope of the derivative suit as the number of obligations owed by managers is constricted. This variant differs from the first, which concedes that management violated its fiduciary duties but concludes that the shareholders should bear that loss to assure their heightened vigilance. In the second variant, no substantive violation has occurred because the challenged conduct stimulates legitimate entrepreneurial activity, results in a net gain to society, and does not harm the corporation. A common concern bounds each variant: in appropriate circumstances, the law should disallow corporate recovery because a recovery would deter socially beneficial activities.

A. Dampened Incentives to Monitor Management

*Cenco Inc. v. Seidman & Seidman*⁴⁰ has its roots in the fraudulent acts of Cenco's management, who for several years deliberately overstated the company's inventories, thereby creating a false impression of profitability. This fraud enabled Cenco to borrow

confining the scope of the business judgment rule, so that managerial ineptitude could also become a basis for liability. *But see* Hetherington, *When The Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 198-99 (1979) (expressing none of these limitations).

40. 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982).

money at lower interest rates and to complete several acquisitions and sales on terms more favorable than if Cenco had truthfully reported its income.⁴¹ Seidman & Seidman, Cenco's auditor during the period of management's fraudulent acts, initially failed to discover the defalcations and later consciously ignored signals indicating that Cenco's inventories were inflated.⁴² After making an \$11 million settlement of a class action by investors who purchased Cenco stock during the fraud,⁴³ Cenco initiated an action against Seidman & Seidman for breach of contract, negligence, and fraud for the auditor's failure to "nip the fraud in the bud."⁴⁴

The narrow question before the Seventh Circuit concerned the propriety of a district court's instruction allowing the jury to consider the auditor's defense that Cenco's top management initiated the fraudulent overvaluations.⁴⁵ Judge Posner justified the jury's consideration of this defense on the peculiar facts of the case: top corporate management initiated the wrongdoing, the fraudulent scheme furthered the corporation's interest, and the corporation sought recovery against the outside auditors, not its managers. Under this situation, especially in view of evidence that Cenco benefitted by the misconduct, the court upheld the instruction.⁴⁶

Judge Posner justified denial of Cenco's recovery by the effect the holding would have on the shareholders' incentives to monitor their managers. Judge Posner stated that, "if the owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced."⁴⁷

Judge Posner's analysis coincides with an economist's view of legal rules — a perspective to which Judge Posner can hardly be expected to take exception — that legal norms should impose liability not on the culpable, but on those best able to avoid the loss efficiently.⁴⁸ To the question who should bear the loss arising from an accident, the economist answers: the party with the lowest costs to avoid the accident.⁴⁹ If the plaintiff has the lowest cost

41. *Id.* at 451.

42. *Id.* at 452.

43. *Helfand v. Cenco Inc.*, MDL Docket No. 291, No. 75C 2227 D.C. No. Ill., reported at Wall St. J., Feb. 13, 1978, at 25, col. 3.

44. *Cenco*, 686 F.2d at 452.

45. *Id.* at 454.

46. *Id.* at 456.

47. *Id.* at 455.

48. See generally G. CALABRESI, *THE COST OF ACCIDENTS* (1970); Brown, *Toward an Economic Theory of Liability*, 2 J. LEGAL STUD. 323 (1973) (a formalized analysis of economic effects of liability rules); Calabresi, *Optimal Deterrence and Accidents*, 84 YALE L.J. 656 (1975) (an explanation of what the fault system and strict liability mean in terms of minimizing accidents and accident prevention costs); Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120 (1982) (an examination of how liability rules and insurance affect incentives to reduce accident risks and their allocation); Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980) (a comparison of strict liability and negligence rules on the basis of the incentives they provide to "appropriately" reduce accident losses).

49. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 122-24 (2d ed. 1977). There are in-

of accident avoidance, permitting recovery destroys his incentive to adopt suitable preventive measures. Transposed to the facts in *Cenco*, the stockholders had the lowest cost to avoid their managers' fraud under Judge Posner's assumption that they could have exercised more diligence in voting for directors and monitoring their performance. The court, however, overlooked the shareholders' employment of Seidman & Seidman as a device to monitor their managers. The essence of the independent auditor's function is economic efficiency.⁵⁰ Individual investors may not efficiently commission their own inspection of management's financial reports. That function can be achieved collectively by a proportional sharing of the cost among all the shareholders when the corporation engages independent auditors. Therefore, *Cenco*, and more importantly its shareholders, selected and employed an apparently economical and effective monitoring device.

Because the commissioning of outside auditors constitutes an efficient and reasonable step toward monitoring management, the facts of *Cenco* raise a question entirely different from that perceived by Judge Posner. The court should have focused not on the conduct of *Cenco*'s shareholders, but on whether Seidman & Seidman could curb its employees' misbehavior better than *Cenco*'s shareholders could monitor the monitors. Judge Posner overlooked the accounting firm's duty "to play an active role in hiring and supervising"⁵¹ its personnel. The result he reached reduces, rather than heightens, the shareholders' incentives to adopt the least costly method to protect against management misbehavior.⁵² A better result in *Cenco* would have followed the rule established in other states that permits firms to recover so long as the managers' misdeeds do not contribute to the accountant's failure to perform his contract.⁵³

stances, of course, in which the avoidance cost exceeds the accident's discounted loss in which the most economical solution is for the legal rule to permit this smaller cost to occur. *Id.* at 122.

50. See Watts & Zimmerman, *supra* note 11, at 614.

51. *Cenco*, 686 F.2d at 456.

52. Shareholders who cannot rely on their monitors, or on the courts to impose liability on their monitors, have every incentive to dispense with their monitors' services altogether or to employ more costly steps.

53. The leading case for this proposition is *National Surety Corp. v. Lybrand*, 256 A.D. 226, 9 N.Y.S.2d 554 (1939), which distinguished a contrary result reached in *Craig v. Anyon*, 212 A.D. 55, 208 N.Y.S. 259 (1925), *aff'd mem.*, 242 N.Y. 569, 152 N.E. 431 (1926), on the basis that in *Craig* the employer represented that the employee was trustworthy. 256 A.D. at 236, 9 N.Y.S.2d at 563. *Lybrand* has been followed in most contemporary disputes. See, e.g., *Shapiro v. Glekel*, 380 F. Supp. 1053 (S.D.N.Y. 1974) (specifically adopting the *Lybrand* rationale); *Cereal Byproducts Co. v. Hall*, 8 Ill. App. 2d 331, 132 N.E.2d 27 (1956) (citing *Lybrand* in rejecting accountants' defense of contributory negligence because there was no evidence that the corporation contributed to the accountants' negligence). See also Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 809-12 (1959) (accepts contribu-

Judge Posner's reasoning would apply equally to derivative actions against outside directors who, for example, knowingly acquiesce in violations of environmental laws to reduce the corporation's manufacturing costs. One could argue, as in *Cenco*, that corporate recovery from outside directors for the fine and litigation costs arising from public prosecution of the corporation would dampen the shareholders' incentives to assure their corporation stayed within the bounds of the law. This argument, however, overlooks the integral — if not indispensable, in the view of the ALI's corporate governance project — role of outside directors in monitoring management. In fact, established case law holds directors liable to the extent that their knowing violations of criminal statutes cause an economic loss to the corporation.⁵⁴ This result is even more compelling when the issue implicates a monitoring function. As noted earlier,⁵⁵ a separation of ownership from control characterizes public corporations, causing distinct informational asymmetries to accompany managerial misbehavior. Because of these asymmetries, harm to the corporation and, in turn, the shareholders, often occurs before shareholders have any reasonable basis for concern. Shareholders become aware of misfeasance only after its full impact is felt. For example, in *Cenco*, the public disclosure of management's inflation of ending inventory only occurred after five years of stock purchases at inflated prices by innocent investors. Their purchases gave rise to Cenco's \$11 million settlement, the most tangible evidence of the harm to Cenco and its shareholders who did not participate in the settlement. The fallacy of Judge Posner's decision in *Cenco* was not his *ex ante* approach to incentives for shareholders to monitor their managers, but his failure to realize that despite reasonable monitoring devices there remains misbehavior that monitoring cannot economically detect.⁵⁶ Auditors and outside directors are more efficient monitoring devices than are shareholders' personal investigations, and it turns the notion on its end to suggest, as does Judge Posner, that shareholders must monitor their monitors. Monitoring is economical only to a point. Thereafter, standard notions of fiduciary and contractual obligations must provide both a deterrent to breaches and a method for analyzing the consequential harm suffered.⁵⁷ This analysis returns to traditional considerations of deterrence and compensation and avoids the myopia of driving shareholders to perform uneconomical tasks.

B. Liability and Risk Taking

The more conventional concern expresses the fear that overly broad determinations of liability may systematically fetter legiti-

tory negligence as defense to accountants' malpractice if plaintiff's conduct actually affects defendant's ability to do his job with reasonable care); *Accountant's Malpractice Liability to Client*, Annot., 92 A.L.R. 3d 396 (1979).

54. See cases cited *infra* note 92.

55. See *supra* text accompanying note 4.

56. Jensen & Meckling, *supra* note 4, at 324-25.

57. Anderson, *supra* note 37, at 784-86.

mate entrepreneurial activities while reaching infrequent violations. This dynamic occurs as courts consider whether the business judgment rule, which reflects the judiciary's awareness of the need to encourage managerial risk taking,⁵⁸ protects managerial actions. A manager's role includes risk seeking because greater returns usually lie with business opportunities having greater risk.⁵⁹ The link between risk and return offers a compelling defense to managerial decisions. An overly intrusive judicial attitude in derivative-suit challenges to managers' decisions would discourage legitimate and necessary entrepreneurial risk taking.⁶⁰ A heightened level of judicial scrutiny raises genuine fears that managers will become liable for losses arising from normal business decisions. This fear causes managers to develop costly records, purchase insurance, and incur litigation expenses. The volatility of the business environment and the frequent need to make decisions on incomplete information⁶¹ exacerbates these fears and has a concomitant effect on risk taking, producing ever more costly steps to guarantee against liability. Theoretically, courts must consider the circumstances surrounding a decision in judging managers' performance. Nonetheless, the crispness with which triers of fact understand those circumstances as they then existed, as contrasted with their reconstruction through the benefit of hindsight, interjects a pernicious dimension into judicial activism. Furthermore, directors are selected, at least in the normative view, because of their experience, knowledge, or sensitivity to production, finance, or the marketplace. These are not entry level qualifications to the judiciary.

Professor Scott adds to these concerns several other fears that cause him to advocate abolishing derivative suits for duty-of-care violations.⁶² First, he observes that very little would be lost with abolition of care-based derivative suits because few of these cases ever impose liability.⁶³ Professor Scott attributes the failure to

58. See, e.g., *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

59. See Anderson, *supra* note 37, at 775-76; Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295 (1980); Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1559-60 (1982).

60. Directors and their representatives repeatedly emphasize this fear. See Statement of the Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations" 36-51 (Feb. 1983); Smith, *Corporate Governance: A Director's View*, 37 U. MIAMI L. REV. 273, 289-91 (1983).

61. See Feinberg & Levenstein, *How Do You Know When to Rely on Your Intuition*, Wall St. J., June 21, 1982, at 16, col. 3.

62. Scott, *supra* note 39.

63. *Id.* at 932-33. Professor Bishop's insight on this matter three decades ago re-

impose liability to the absence of any departure in goals between shareholders and managers.⁶⁴ He reasons that managers benefit as much as shareholders from sound, profitable decision making, because of the prevalence of certain market incentives: takeovers, proxy contests, reputational standing, and performance-based compensation plans.⁶⁵ Systematic shirking or inattentiveness will, according to Professor Scott, trigger one or more of these devices. Professor Scott's second justification for abolishing the duty of care lies in his perception of the distinction inherent between the type of decision litigated in care cases as opposed to loyalty cases. He finds that care suits involve significant problems separating bad outcomes into two categories: those due to bad luck and bad decision making. Courts can easily hold that the manager ought to have anticipated the bad luck, thereby recharacterizing the outcome as bad decision making.⁶⁶ Professor Scott, however, allows that the element of personal gain inherent in loyalty lawsuits narrows the inquiry, making the determination easier.⁶⁷

Professor Scott appears to recommend a specific application of more deeply developed theories on the relative strengths and weaknesses of market-based responses to managerial misbehavior.⁶⁸ As seen earlier,⁶⁹ market-based displacement devices effectively respond to, and therefore deter, prolonged managerial misconduct, not one-shot misbehavior. Professor Scott adds a characterization test to the literature favoring market-based solutions to managerial misconduct, substituting "care" and "loyalty" violations where others have spoken in terms of "one-shot" and "prolonged misconduct"⁷⁰ standards for pre-trial screening of cases more suitably addressed by market forces. Professor Scott's precise litmus is the presence of managerial self-interest or self-dealing, the same standard taken in the proposal to the ALI for making discrete procedural choices for the conduct of the derivative suit.⁷¹

While Professor Scott's prescription for the duty of care rests upon a market-based approach to managerial misconduct, it bears none of the qualifications that have led other proponents of the market to counsel less sweeping conclusions. For example, Professor Scott recognizes that in duty-of-loyalty cases, "the gains from ousting self-rewarding management must become quite siza-

mains unchallenged. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968).

64. Scott, *supra* note 39 at 935-37.

65. *Id.*

66. *Id.* at 946.

67. *Id.*

68. See *supra* text accompanying notes 31-39.

69. See *supra* text accompanying note 33.

70. See *supra* note 33.

71. Others have also counselled this approach. See Buxbaum, *Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122 (1980); Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 322 (1981).

ble before they outweigh the costs,"⁷² he overlooks the presence of this same concern in duty-of-care cases. Moreover, there remains the practical consideration that most corporations are not publicly traded. No dynamic market exists for managers of small privately held corporations. Therefore, for the great bulk of American corporations, market-based solutions are not available, making private litigation a necessity.

Moreover, there is serious doubt that Professor Scott's major thesis — that an important distinction exists in the type of decision and pattern of evaluation between care and loyalty cases — stands up to close scrutiny. Professor Scott calls for greater judicial activism in loyalty cases because he believes they involve the courts in familiar tasks without encroaching upon an area better suited to the education, experience, and skills of managers.⁷³ For example, Professor Scott implores courts to make their own "fairness" judgments in loyalty cases,⁷⁴ but renders them unqualified to evaluate decisions prompted by suits alleging care violations. These analytical distinctions are not intuitively obvious. The clear learning of loyalty cases is that the burden of proof shifts to the defendant managers, but that the fairness determinations, which necessarily occur in loyalty cases, always implicate the same business issues that challenges to wasteful and careless decision making implicate.⁷⁵

Overall, Professor Scott's recommendation overstates the perils of the duty of care. His recognition of the omnipotent market force driving managers to serve their corporations' interests and the dearth of cases finding care violations proves too much. Rather than supporting his conclusion that the duty of care causes more harm than good, his arguments appear to show that the standard is superfluous. One cannot justify violations of the duty of care by invoking notions of deterrence because the duty's demands are not sufficiently great so as to drive managers toward an optimal level of performance. In its most rigorous form, the duty

72. Scott, *supra* note 39 at 939.

73. *Id.* at 946.

74. *Id.* at 939-40.

75. See, e.g., Scott v. Multi-Amp. Corp., 386 F. Supp. 44 (D.N.J. 1974) (director has burden of proving he and corporation are honest, fair, and reasonable); Hadden v. Krevit, 186 Conn. 587, 442 A.2d 944 (1982) (officers and directors have burden of showing loans made to small, closely held corporation were fair, in good faith, and for adequate consideration); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (individuals implementing and fixing terms of option agreement between two corporations, while serving as directors and officers of both corporations, have burden of demonstrating intrinsic fairness of transaction); Aronoff v. Albanese, 85 A.D.2d 3, 446 N.Y.S.2d 368 (1982) (objecting stockholder must prove that no person of ordinary sound business judgment would say corporation received a fair benefit from an alleged gift or waste of corporate assets).

of care only requires that managers have a reasonable basis for their decisions, despite the availability of more compelling alternative choices available to them.⁷⁶ Such a low standard is poorly conceived to encourage managers to maximize the firm's performance. Simply stated, the duty of care is a standard of minimal legal performance which hardly commands respect in the marketplace. Care violations exist and serve to compensate the corporation for egregious managerial misbehavior.⁷⁷ No paper trail shields this level of misbehavior; the threat of liability for such extreme conduct will discourage no meaningful entrepreneurial activity.

Furthermore, the type of case likely to result in liability under the duty of care does not involve continuing managerial ineptitude as Professor Scott suggests. In cases involving continued ineptitude, the reasonable basis standard will be satisfied easily, thus a difficult causality issue between the breach and harm arises to shield the managers.⁷⁸ Rather, care cases usually involve one-time decisions that the plaintiff also asserts implicate a less obvious loyalty question and the defendant successfully argues is neither.⁷⁹ Professor Scott's conclusion introduces an unwieldy and dysfunctional requirement that courts characterize the suit as a care or loyalty case on the pleadings before the plaintiff has had the opportunity to support general allegations by discovery. Judge Seitz, in *Lewis v. Curtis*,⁸⁰ responded to a similar suggestion when considering the derivative-suit defendant's argument that an important procedural requirement should depend upon the substantive claim of the derivative complaint. The case posed the specific question whether the derivative suit could proceed if the com-

76. For specific case illustrations, see *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168, 1180, 1194 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert denied*, 454 U.S. 1092 (1981); *Elfenbein v. American Fin. Corp.*, 487 F. Supp. 619 (S.D.N.Y. 1980); *Muschel v. Western Union Corp.*, 310 A.2d 904, 908-09 (Del. Ch. 1973); *Warshaw v. Calhoun*, 43 Del. Ch. 148, 159, 221 A.2d 487, 494 (1966). This protective facet of the business judgment rule has been commented upon extensively. See, e.g., *Arsht, Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 660-64 (1979) (business judgment rule shields director from liability for authorizing transaction involving no self-dealing or self-interest if that director exercises due care to ascertain relevance of all available facts, reasonably believes transaction is in best interest of corporation, and acts in good faith); *Arsht & Hinsey, Codified Standard — Safe Harbor but Chartered Channel: A Response*, 35 BUS. LAW. 947, 958 (1980) (business judgment rule protects directors against liability for good-faith mistakes in judgment and for unpopular business decisions); *Bishop, supra* note 63, at 1099-1101 (corporate directors run little risk of liability for ordinary negligence not involving self-dealing); *Veasey & Manning, Codified Standard — Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 930-40 (1980) (business judgment rule is responsible for courts' reluctance to examine merit of director's good faith, informed consent).

77. *Bishop, supra* note 63, at 1099-1100.

78. *Barnes v. Andrews*, 298 F. 614, 616 (S.D.N.Y. 1924) (imposing upon the plaintiff, in care cases, the burden of proving both the breach and establishing that the breach proximately caused loss).

79. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert denied*, 454 U.S. 1092 (1981); *Kamin v. American Express Co.*, 86 Misc. 2d 809, 383 N.Y.S.2d 807 (Sup. Ct.), *aff'd*, 54 A.D.2d 653, 387 N.Y.S.2d 993 (1976).

80. 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982).

plaint failed to allege facially improper conduct by the directors.⁸¹ Judge Seitz correctly decided that the plaintiff's ability to maintain the suit should not depend on the nature of the complaint because to so hold would impermissibly create a pleading defense to a factual dispute.⁸² Similarly, care and loyalty cases defy neat compartmentalization, especially at the pleading stage. Both kinds of cases implicate the same patterns of analysis in judging the reasonableness or fairness of the managers' conduct and have involved one-shot violations, not systematic shirking. For these reasons, the notion that the scope of the corporation's rights and the procedures through which to vindicate those rights should not depend upon a pretrial characterization of the nature of the suit and cannot be justified out of a concern for discouraging entrepreneurial risk taking.

III. *The Compensatory Undertow*

The case law contains few decisions which question the purpose of the corporate recovery. Two early cases sound a hopeful note for the ALI Reporters, whose provisions reflect the philosophy that deterrence predominate when a compensatory purpose is lacking. *Roth v. Robertson*⁸³ arose when the manager of an amusement park paid "hush money" to individuals who threatened to prevent the park from operating in violation of the state's Sunday closing laws. The court upheld a jury award of \$800 in a derivative suit, even though the corporation obtained a large percentage of its patronage from Sunday excursionists, other managers approved the payment, and the plaintiff had acquiesced in the payment. The court permitted recovery because the hush payment not only violated a criminal statute, but affronted the business community's moral standards.⁸⁴

Significantly, the only defense raised in *Roth*, a defense which the court invalidated, was the plaintiff's acquiescence.⁸⁵ The defense did not argue that the corporation incurred a net benefit as a result of the hush payment. In fact, the court's reasoning, which conditions liability upon proof that the directors caused a "loss to the corporation,"⁸⁶ implies this defense. The court emphasized that the payment, in addition to affronting society's standards, constituted *waste* of the corporate assets,⁸⁷ suggesting a different result if the corporation profited from the infraction.

81. *Id.* at 785-86.

82. *Id.* at 786.

83. 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909).

84. *Id.* at 346, 118 N.Y.S. at 353.

85. *Id.* at 345, 118 N.Y.S. at 353.

86. *Id.*

87. *Id.* at 346, 118 N.Y.S. at 353.

The other decision, *Abrams v. Allen*,⁸⁸ involved a derivative suit challenging Remington Rand Incorporated's dismantling and removal of its plants to intimidate union organizing efforts and to punish its employees for their receptivity to unionization. A crucial paragraph in the complaint charged that the board knowingly abdicated its power to *name* James H. Rand, Jr., whom the board knew was motivated "by malice, bias and personal prejudices"⁸⁹ rather than by a desire to further the interests of the corporation. Moreover, the corporation allegedly suffered a financial loss because of the acts.⁹⁰ The court held that the plaintiff might possibly recover under one of four alternate theories. According to one of the court's theories, illegal misconduct alone subjects its perpetrator to liability.⁹¹ However, none of the cases cited in the decision supports this basis for a corporate recovery. *Abrams*' remarks, therefore, on the connection between illegal activity and a corporate recovery, were merely dicta.

Support for the deterrence theory of corporate recovery has weakened considerably since the *Roth* and *Abrams* decisions. Under the prevailing rule today, derivative suit plaintiffs must establish not only that a knowing criminal act caused an economic loss to the corporation, but that the resulting loss exceeded the competitive benefits garnered through the violation.⁹² Despite this well-established limitation on the derivative suit, *Roth* and *Abrams* remain important beacons, attracting judicial attention to the derivative suit's deterrent potential. The court cited both decisions approvingly in *Miller v. American Telephone & Telegraph Co.*,⁹³ a derivative suit seeking to recover a \$1.5 million phone bill of the Democratic National Committee which AT&T's directors forgave. The plaintiffs challenged the directors' actions as an unlawful political contribution. Relying upon *Roth* and *Abrams*, the court held that the business judgment rule did not shield directors who knowingly violated criminal statutes.⁹⁴ The court found that the dictum in *Abrams* expressed the attitude of the New York judiciary that "directors must be restrained from engaging in activi-

88. 297 N.Y. 52, 74 N.E.2d 305, 79 N.Y.S.2d 305 (1947).

89. *Id.* at 55, 74 N.E.2d at 306, 79 N.Y.S.2d at 306.

90. *Id.*

91. *Id.* at 55-56, 74 N.E.2d at 306-07, 79 N.Y.S.2d at 306-07 (citing *Gath Gaslight v. Claffy*, 151 N.Y. 24, 45 N.E. 390 (1896); *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912); and *Berkey v. Third Ave. R.R.*, 244 N.Y. 84, 155 N.E. 58 (1926)).

92. *Smiles v. Elfred*, 149 N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (N.Y. Sup. Ct. 1963); *Bordon v. Cohen*, 231 N.Y.S.2d 902 (1962); *Clayton v. Farish*, 191 Misc. 136, 73 N.Y.S.2d 727 (N.Y. Sup. Ct. 1947). See also, *Miller v. American Tel. & Tel.*, 507 F.2d 759 (3d Cir. 1974); Forte, *Liabilities of Corporate Officers for Violations of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313, 333-39 (1965) (if defendant's wrongful action both damages and benefits the corporation, the plaintiff must prove a net loss existed to meet the damage requirement); Note, *Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 174, 179 (1964) (net loss damages are a necessary element of a derivative action and once pleaded by plaintiff the burden should shift to the defendant to show net gain).

93. 507 F.2d 759, 762-63 (3d Cir. 1974).

94. *Id.* at 763.

ties which are against public policy.”⁹⁵ The court did not consider whether the need to establish a tangible injury to the corporation limited *Roth*. *Miller*, a diversity action, was bound by New York law which limits a corporation’s right to recover for its fiduciaries’ knowing illegal acts to instances in which the corporation suffers a net loss through those acts.⁹⁶ *Miller* and the authorities it cites make clear what *Roth* may have implied: a corporate recovery against its fiduciaries for unlawful activities can occur only when the harm from the misconduct exceeds the benefit. This limitation prevents the derivative suit from serving as a vehicle for redressing social harms committed by the corporation’s managers. However offensive the conclusion that within the derivative suit context “crime pays,” the net loss requirement may signal no more than the fact that the derivative suit is otherwise a poor medium for enforcing societal directives not devoted exclusively to the corporation’s efficient performance.⁹⁷ The state’s concern for pure air and water, safe consumer products, and fair employment practices implicates protections for a more diverse group than the class of shareholders with standing to maintain a derivative suit. When the deterrence question is instead focused upon a threatened harm to the shareholders themselves, there is a stronger basis to permit some recovery out of prophylactic considerations to remind the directors and officers that their ultimate responsibilities are to the shareholders.

The requirement of actual injury is even broader than that expressed in the cases involving violations of criminal statutes. The courts regularly bar recovery if the corporation has admittedly been damaged but its present stockholders have suffered no loss.

95. *Id.* at 762.

96. The court in fact referred to a more liberal position of the New York law that allows recovery upon proof that the corporation suffered a loss *independent* of those suffered in the criminal prosecution. *Id.* at 763 n.5. The law of New York, however, appears to include a total accounting of all gains and losses, including those associated with the criminal misconduct. See authorities cited *supra* note 92.

97. This is nicely illustrated by an example contained in the proposals to the ALI wherein the board of directors, in violation of an applicable corporate statute, indemnified an officer who was found to have embezzled corporate funds. CORPORATE GOVERNANCE, *supra* note 2, § 7.08 illustration 12, at 330-31. Denial of the defense that the officer’s continued valuable services would be lost if such embezzlement did not occur pits this corporate economic concern against the protection provided shareholders’ by the corporate indemnification statute, rather than a more broadly based noncorporate concern. In this same respect, *Miller v. American Tel. & Tel.*, 507 F.2d 759 (3d Cir. 1974), reasoned that a derivative suit premised on illegal corporate political contributions fulfilled the criminal statute’s concern that shareholders were often harmed by such payments. In a somewhat related fashion, limits on materiality within the disclosure obligations of the federal securities laws have been premised upon matters germane to the economic interests of the shareholders and not upon broader social or political concerns. See, e.g., *Gaines v. Haughton*, 645 F.2d 761, 778-79 (9th Cir. 1981).

The Supreme Court's decision in *Bangor Punta Operations, Inc. v. Bangor & Aroostock Railroad*⁹⁸ offers a classic illustration of this view. There the Court barred a corporation's recovery from its former controlling stockholder because plaintiffs presented no evidence that the defendant's wrongdoing resulted in a financial loss to the corporation's present dominant stockholder. In 1964, Bangor Punta Corporation, through its wholly owned subsidiary, Bangor Punta Operations, Inc., acquired 98.3% of the stock of Bangor Aroostock Railroad Co. (BAR). It later sold those shares to Amoskeag Company at their fair value of \$5 million. Once in control of BAR, Amoskeag Company caused BAR to sue Bangor Punta Corporation and its subsidiary for \$7 million, the amount allegedly misappropriated from BAR by the defendants during their years of control. The Court of Appeals for the First Circuit refused to dismiss BAR's action, relying in part on the need to deter mismanagement, particularly in a quasi-public corporation such as BAR.⁹⁹ The Supreme Court treated the corporation and its stockholders as inseparable for the purpose of evaluating the suit. The Court barred the action because it reasoned that any recovery by BAR would be a windfall to Amoskeag Company,¹⁰⁰ which acquired its shares from the defendant and, as the dominant shareholder, would reap nearly all the recovery's benefits.

In rejecting the First Circuit's decision to permit recovery to deter wrongdoing in spite of the lack of a compensatory function, the Supreme Court embraced the so-called vicarious-incapacity principle established by Commissioner Pound in *Home Fire Insurance Co. v. Barber*.¹⁰¹ There Commissioner Pound rejected the deterrence argument made by a corporation whose sole shareholder acquired his shares from the defendant at an admittedly fair price. Commissioner Pound held that equity courts would redress wrongs but not out of a desire to punish the wrongdoer. He reasoned: "If a wrongdoer deserves to be punished, it does not follow that others are to be enriched at his expense by a court of equity. A plaintiff must recover on the strength of his own case, not on the weakness of the defendant's case."¹⁰²

Some courts explain the decision in *Barber* and its progeny,¹⁰³ which now includes *Bangor Punta*, as depending upon more than concern for unjust enrichment.¹⁰⁴ Historical concerns about ero-

98. 417 U.S. 703 (1974).

99. *Bangor & Aroostock R.R. v. Bangor Punta Operations, Inc.*, 482 F.2d 865, 868 (1st Cir. 1973), *rev'd*, 417 U.S. 703 (1974).

100. *Bangor Punta*, 417 U.S. at 716-17.

101. 67 Neb. 644, 93 N.W. 1024 (1903).

102. *Id.* at 673, 93 N.W. at 1035.

103. See generally *Noland v. Barton*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,631 (10th Cir. Aug. 20, 1984); *In re REA Express, Inc.*, 412 F. Supp. 1239 (E.D. Pa. 1976); *Capitol Wine & Spirit Corp. v. Pokrass*, 277 A.D. 184, 98 N.Y.S.2d 291 (1950), *aff'd*, 302 N.Y. 734, 98 N.E.2d 704 (1951).

104. See, e.g., *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.*, 417 U.S. 703, 716-17 (1974); *National Union Elec. Corp. v. Matsushita Elec.*, 498 F. Supp. 991, 999 n.9 (E.D. Pa. 1980); *Courtland Manor, Inc. v. Leeds*, 347 A.2d 144 (Del. Ch. 1975); *Capi-*

sion of the contemporaneous ownership requirement and about shares tainted by their transferor's misconduct have also motivated these results. However, neither of these additional concerns appears compelling. Courts established the requirement of contemporaneity to discourage strike suits and to prevent the contrivance of grounds for federal diversity jurisdiction.¹⁰⁵ Strike suits cause concern because they damage the corporation by diverting managers from the corporation's business and can cause extortionate settlements at the corporation's expense. Fear of such abuses, however, is misplaced when the corporation itself brings suit against parties no longer associated with the corporation or its business. Moreover, the abolition of federal corporate law and the expansion of state long-arm statutes have removed the concern that parties may use friendly diversity suits to contrive grounds for federal jurisdiction. More importantly, when the corporation initiates suit, the argument that the plaintiff has contrived grounds for diversity jurisdiction using a stockholder's citizenship evaporates because the corporation's own characteristics determine whether citizenship is diverse from the defendants.¹⁰⁶ Therefore, these theories no longer support the vicarious incapacity principle. The remaining justification for vicarious incapacity is a preoccupation with compensation for which concern of a "taint" on the shares has a poorly defined role.

The *National Union Electric Corp. v. Matsushita Electric*¹⁰⁷ decision offers insight into the significance of the defendants' prior ownership of the control shares under the vicarious-incapacity principle. In 1970, National Union Electric Corporation filed an antitrust suit against several other corporations.¹⁰⁸ Electrolux, through a combined tender offer and freeze-out merger, acquired 100% of National Union's stock in 1973. The defendants then sought dismissal of the antitrust action, citing *Bangor Punta* and *Barber*. The court held that, because the antitrust action was ongoing when Electrolux offered to acquire the National Union

tol Wine & Spirit Corp. v. Pokrass, 277 A.D. 184, 98 N.Y.S.2d 291, 292 (1950), *aff'd*, 302 N.Y. 734, 98 N.E.2d 704 (1951).

105. Note, *Corporate Incapacity To Sue Where Stockholders Would Be Barred From Suing Derivatively — The Vicarious Incapacity Rule: A Public Interest Exception*, 54 B.U.L. REV. 355, 370-73 (1974).

106. 28 U.S.C. § 1332 (1976). See *Indianapolis v. Chase Nat'l Bank*, 314 U.S. 63 (1941) (looking beyond the pleadings and arranging parties on the side they actually belong for diversity purposes).

107. 498 F. Supp. 991 (E.D. Pa. 1980).

108. The defendants were Sanyo Electric Co., Ltd.; Sanyo Electric Trading Co., Ltd.; Sanyo Electric, Inc.; Toshiba Corp.; Toshiba Am., Inc.; Hitachi Ltd.; Hitachi Sales Corp. of Am.; Matsushita Electric Indus. Co.; Matsushita Electric Corp. of Am.; Mitsubishi Corp.; Mitsubishi Int'l Corp.; Sony Corp.; Sony Corp. of Am.; Sharp Corp.; and Sharp Electronics Corp.

shares, the Electrolux and National Union shareholders could not have ignored the value of the antitrust suit in establishing the price for National Union.¹⁰⁹ The court reasoned that some portion of the offering price must have reflected the estimated value of National Union's antitrust claim. The combination of the parties' expectation and a preoccupation with avoiding unbargained-for gain superficially suggests that Electrolux's recovery be limited by the amount it paid for the suit. The court rejected this limitation, but its reasoning appears empty. The court held that to limit National Union's recovery would irreconcilably conflict with courts' traditional refusal to question the adequacy of consideration.¹¹⁰ According to the court: "using the veil-piercing device as a means to bar a newly acquired corporation from pursuing a preexisting lawsuit or to minimize its possible recovery would turn the law on its head."¹¹¹

If this argument means simply that the corporation's suit may proceed so long as it contains a compensatory aspect, it becomes difficult to reconcile *National Union* with *Bangor Punta*, because approximately one percent of the recovery sought in *Bangor Punta* belonged to the minority shareholder and, therefore, was compensatory. It would, therefore, seem that the court's response to the defendant's argument in *National Union* involves more than a search for compensation, however small. Parties negotiating the price of an asset, such as rights to a lawsuit, the outcome of which is uncertain, will contemplate a wide range of possible outcomes and attach different probabilities to each outcome's occurrence. The asset's price will consist of a value they negotiate that reflects their views of the expected outcomes, weighted by the probability of each outcome's occurrence. Thus, whatever increment Electrolux paid for control of National Union is attributable to the lawsuit's value; that price embodied all possible outcomes associated with that action. The perceived risk associated with its occurrence further discounts the price. Even if Electrolux acquired National Union directly from the defendants and paid for the cause of action, the court should not limit Electrolux's recovery by the amount paid to prosecute the claim any more than it should allow Electrolux to recover the amount paid if the action is subsequently nonsuited,¹¹² as later occurred.¹¹³

Arguably, the resolution of cases in which managerial misconduct has clearly injured the corporation should depend upon whether the parties could expect prosecution of the claim.¹¹⁴

109. *National Union*, 498 F. Supp. at 1004.

110. *Id.* at 1005.

111. *Id.*

112. Cf. Brudney, *The Bankruptcy Commission's "Proposed Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305, 332 (1974).

113. *Zenith Radio Corp. v. Matsushita Elec. Indus. Co.*, 513 F. Supp. 1100, 1331 (E.D. Pa. 1981).

114. *National Union*, 498 F. Supp. at 1004. See Note, *Survival of Rights of Action After Corporate Merger*, 78 MICH. L. REV. 250, 262-70 (1979).

However, a significant change in ownership after that injury confuses the issue of recovery. In cases like *Barber* and *Bangor Punta*, where the plaintiff purchased control directly from the wrongdoer, there was no showing that the negotiated purchase price included a corporate action against the seller of control.¹¹⁵ That assumption becomes quite appropriate under the facts of *National Union* where the suit was pending when the plaintiffs purchased control from shareholders who bore no responsibility for the misconduct.

An analogous problem arises when the corporation acquires the cause of action in a merger. Recently, in *Lewis v. Anderson*,¹¹⁶ the Delaware Supreme Court held that actions automatically pass to the acquiring corporation and that the derivative suit, initiated in advance of the merger against the acquired company's managers, must therefore be dismissed.¹¹⁷ The court justified its conclusion by technically reading several provisions of the Delaware General Corporation Law¹¹⁸ and by reasoning that its holding coincided with the vicarious-incapacity principle. The *Lewis* court distinguished *Bangor Punta* on the ground that the acquiring corporation takes into consideration the potential worth of the target corporation's lawsuits in determining the price to pay to acquire control.¹¹⁹ The *Lewis* court's approach is therefore consistent with that of *National Union* regarding the parties' probable expectations when plaintiffs purchase control from someone other than the defendants and the suit is pending on the date of the transaction.¹²⁰ However, because the *Lewis* court relied on an interpretation of state statutes, Delaware law will treat the parties' expectations as conclusive in all cases. This is an unfortunate conclusion.

115. Certainly it is beyond reason to believe that BAR knowingly sold a corporation and a cause of action against BAR having a potential combined worth of \$12 million for only the amount conceded to be the fair value of the company's operations sheared of the action against BAR.

116. 477 A.2d 1040 (Del. 1984).

117. *Id.* at 1049.

118. The court harmonized three sections. Section 259(a) provided, in part, that upon merger, all rights, property, and debts of each merging company along with "all other things in action or belonging to each of such corporations shall be vested in the corporation surviving or resulting from such merger. . . ." Section 261 provided that "any action or proceeding . . . pending by or against any corporation which is a party to a merger or consolidation shall be prosecuted as if such merger or consolidation had not taken place, or the corporation surviving or resulting from such merger or consolidation may be substituted in such action or proceeding." Section 327 required that in any derivative suit "it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law."

119. *Lewis*, 447 A.2d at 1040.

120. See *supra* notes 107-115 and accompanying text.

From the stockholders' perspective, the question raised in *Bangor Punta* and *Lewis* is whether the defendant's conduct has caused the shareholder an uncompensated harm. The automatic rule of *Lewis* is inconsistent with *Bangor Punta* because the former allows recovery by a noncontemporaneous shareholder with a significant ownership interest, whereas the latter saw this as grounds for dismissal. Moreover, *Lewis* automatically bars suit by shareholders existing at the moment of the breach so that they may, as occurred in *Lewis* itself, not be compensated for the harm they suffered as a consequence of the former managers' misbehavior. Furthermore, the acquiring corporation may have acquired control at a price depressed by the defendants' misbehavior, much as occurred in *Bangor Punta*, with the sole distinction being that control was acquired from someone other than the suit's defendants. This includes as well the likelihood that no portion of the acquisition price can be presumed to include payment for the right to proceed on the corporation's cause of action for its former managers' misbehavior because the suit was not in existence when control was acquired, as occurred in *National Union*. For these reasons, it appears that *Lewis* cannot be viewed as advancing either a deterrent or compensatory function; it is purely a formalistic result guided by a technical reading of the Delaware statutes.

Expediency appears as well to underlie the holding of *Barber* and its progeny. Lying well within the distinction between *National Union* and *Barber* is the notion of the parties' probable expectations. It is not reasonable to assume under the facts of *Barber* and *Bangor Punta* that any portion of the purchase price paid to the defendants represented the expected value of the suit against the former control person. To be sure, the fair price for the firm necessarily includes a range of prices, such that the purchaser may have been willing to pay a price nearer the high end of this range if he contemplated that a right to recover for prior managerial misdeeds accompanied the purchase of the firm. But such contemplation is not to be expected to be a mutual one because it is in conflict with the seller's interest not to sell control to one who would seek to recoup a portion of the purchase price from the seller in a suit for the seller's earlier misdeeds. It is against this backdrop that the metaphorical description of the purchaser's shares being tainted by their seller's wrongdoing serves nicely the parties' probable expectations. On the other hand, this should not serve as a bar to suit under the facts of *National Union* when the suit is not against the seller of the control block of shares. Unfortunately, however, the holding of *Barber* and *Bangor Punta* and their pronouncements of a compensatory function have too frequently blunted the courts' treatment of factual situations in which there has been a significant change in ownership.

Examples of the disservice of the vicarious incapacity principle abound. In *Rock River Savings & Loan Association v. American*

States Insurance Co.,¹²¹ the Seventh Circuit applied *Bangor Punta* to bar a recovery against the firms' accountants who aided five officers in defrauding the firm. Prior to the suit, but after public disclosure of the fraudulent transactions, the officers sold their shares at a discount to a new group of owners. The corporation's insurer, who had been subrogated to the corporation's rights against its former officers as part of the insurer's settlement with the corporation, brought suit.

The court barred the insurer from recovery because under *Bangor Punta* the corporation could not have recovered under the same facts.¹²² The Seventh Circuit ignored the terms of the settlement with the insurer, a settlement between parties not implicated in the wrongdoing and which no doubt included consideration of the action's worth against the firm's former officers and the firm's accountants. Instead, the court blindly applied the litmus of a change in ownership; no consideration was given to the various compensatory strategies assumed by each party during the negotiations. Moreover, the result in *Rock River* is inconsistent with the most restrictive view of the right to pass causes of action to new owners adopted by *Lewis*.¹²³

In *Jannes v. Microwave Communications, Inc.*,¹²⁴ the court partially disallowed a derivative suit because the defendant acquired ninety percent of the corporation's stock after the alleged wrongs had been committed, so that recovery could have fulfilled a compensatory objective, albeit for only ten percent of its shareholders. Instead of permitting the suit to continue and allowing recovery only for those harmed, the court dismissed the case. It is difficult to criticize the dismissal on the ground that it was inconsistent with the purchaser's intention to acquire and prosecute the cause of action. On the other hand, the court could not justify the result by holding that the defendant's purchase ratified the earlier misconduct. The *Jannes* decision represents nothing short of the court's weak commitment toward serving a compensatory function and its wholesale abandonment of deterrence.

As seen above,¹²⁵ the problem of evaluating whether a corporate recovery is compensatory, or instead produces a windfall, defies convenient resolution even in relatively simple cases involving a transfer of control before or after the initiation of the suit. The simplifying assumptions adopted by courts in these cases have frequently proven dysfunctional. In *Rock River*, simplification

121. 594 F.2d 633 (7th Cir. 1979).

122. *Id.* at 635.

123. See *supra* note 116 and accompanying text.

124. 385 F. Supp. 759 (N.D. Ill. 1974).

125. See *supra* notes 107-113 and accompanying text.

shielded an outside wrongdoer where the new controlling shareholders clearly bargained for a recovery.¹²⁶ The *Jannes* decision stands *Bangor Punta* on its end to avoid compensation where the defendant, not the plaintiff, acquired control. A far better approach in each instance would consider carefully who suffered in order to afford compensation. Any relief so provided would contribute as well to the deterrence of managerial misconduct.

Even absent a purchase of a control block of stock after the wrongdoing, in publicly traded corporations corporate recovery poses genuine concerns about unjust enrichment. Ownership constantly changes in public corporations. Those who become shareholders after the disclosure of a manager's misbehavior may have purchased their shares at a deeply discounted price, so that they, much like Amoskeag, reap a windfall by the recovery. Few cases, however, have raised these barriers, perhaps for the reasons expressed in connection with the discussion of *National Union*.¹²⁷ Certainly, when a large number of shares, rather than a distinct control block, trade hands, the difference in scale alleviates fears of windfall. Investors' assumed expectations can control the result. Nevertheless, Judge Posner carried his concern for the compensatory mission of the corporate recovery to its zenith in *Cenco Inc. v. Seidman & Seidman*.¹²⁸

As seen earlier,¹²⁹ Cenco sought indemnification by its accountants, who knowingly aided Cenco's top management in overstating the firm's assets and income, thus benefitting Cenco and its shareholders. Although Judge Posner relied on management's intent to benefit Cenco,¹³⁰ his holding applies to any case involving a substantial change in stock ownership.

The people who will receive the benefits of any judgment rendered in favor of Cenco . . . are Cenco's stockholders, comprising people who bought stock in Cenco before the fraud began, people who bought during the fraud period and either sold afterwards when the stock price fell or continue to hold the stock at a loss, and people who bought after the fraud was unmasked. A judgment in favor of Cenco on its claim against Seidman would not differentiate among these classes but would benefit every stockholder as of the date of the judgment (or the date when a judgment was anticipated with some precision) in proportion to the number of shares he owned.

126. See *supra* notes 121-123 and accompanying text.

127. See *supra* notes 107-113 and accompanying text.

128. 686 F.2d 449 (7th Cir.), *cert denied*, 459 U. S. 880 (1982).

129. See *supra* note 44 and accompanying text.

130. A later Seventh Circuit decision also emphasizes the importance of this factor in distinguishing *Cenco* from the case then before the court. *Schacht v. Brown*, 711 F.2d 1343, 1347-48 (7th Cir.) (the managers' fraudulent acts allegedly prolonged the corporation's existence, thereby increasing its liabilities), *cert. denied*, 104 S. Ct. 5088 (1983). As seen earlier, this distinction is not convincing because, on close analysis, *Cenco* clearly incurred an injury as a consequence of fraudulent acts because its gains were never shown to exceed and were probably less than the \$11 million settlement of the class-action securities suit.

Once the real beneficiaries of any judgment in favor of Cenco are identified, it is apparent that such a judgment would be perverse from the standpoint of compensating the victims of wrongdoing. Among the people who bought stock in Cenco before the fraud began are the corrupt officers themselves. To the extent they are still stockholders in the company, they would benefit pro rata from a judgment in favor of Cenco. The other stockholders in this class are innocent in a sense, but of course it is they who elected the board of directors that managed Cenco during the fraud. The people who bought during the fraud period and either sold at a loss or continue to hold at a loss are the plaintiffs in the recently settled class action in which both Cenco and Seidman were defendants. Seidman has already paid \$3.5 million to them. Those who continue to own stock in Cenco (as distinct from those who sold at a loss) would receive additional compensation if Cenco prevailed in this action against Seidman. This is not to say they would be overcompensated; but it seems odd that the same shareholders should be able to recover damages from Seidman twice for the same wrong — once directly and once, in this suit, indirectly. Finally, the shareholders who bought after the fraud was unmasked lost nothing. The unmasking of the fraud caused the price of Cenco's stock to be bid down to reflect not only the true value of its inventories but also any anticipated injury to the company as a result of the fraud.¹³¹

The shifting ownership of a publicly traded corporation always offers the mismatching envisioned by Judge Posner. Furthermore, the nature of a corporate recovery does not permit a court to make discrete distinctions among the suit's beneficiaries, as in class-action recoveries. For example, in the class-action settlement, the Seventh Circuit approved an arrangement limiting the recovery of Cenco's largest shareholder, Curtiss-Wright Corp., which increased its investment in Cenco after its own audit revealed poor accounting controls and overstated earnings.¹³² The pivotal distinction in *Cenco*, however, remained whether management's misconduct furthered the corporate interest.

Thus, Judge Posner believed that Cenco's settlement of the class actions did not harm shareholders whose ownership antedated the fraud because the corporation's fraudulent gains offset their loss.¹³³ This conclusion involves a highly sophisticated calculation of not only the quantity of corporate benefit derived from the fraud but also of the percentage of current stock ownership which predated the fraud, as well as the relative amounts paid by Cenco and Seidman & Seidman to settle the class actions. None of these areas, however, was inquired into by the court.

131. *Cenco*, 686 F.2d at 455.

132. *Id.* at 456.

133. *Id.*

The settlement fund consisted of \$11 million paid by Cenco¹³⁴ and \$3.5 million paid by Seidman & Seidman. Assuming that eighty percent of Cenco's stockholders at the settlement date purchased their shares during the fraud at the inflated price, they would experience a \$5.7 million net gain because eighty percent of the corporation's contribution to the settlement, \$8.8 million, was money paid to themselves. Thus, their participation in Cenco's recovery against Seidman & Seidman would not make them free riders. Even if the fraud produced an \$11 million gain for Cenco, the shareholders who purchased during the fraud may have suffered a loss in excess of the amount of the entire settlement. The worst one can say for this group is that recovery against Seidman & Seidman adjusts the settlement terms among the defendants, more closely compensating the shareholders for their losses. Indeed, the amount that Cenco paid into the settlement constitutes the base for measuring the benefits necessary to reduce the corporation's right to recover.¹³⁵

As for those who became shareholders after public disclosure of the wrongdoing, their position more closely resembles that of Electrolux in *National Union* than Amoskeag in *Bangor Punta* as purchasers of Cenco shares. After disclosure of the fraud, they had ample basis for assuming that the action against the firm's accountants had some value. Those who owned Cenco shares throughout had no personal out-of-pocket costs; however, the settlement with the first group of shareholders left their corporation \$11 million poorer. A court should deny recovery to this group of shareholders only after the benefits garnered by the equity owners reached \$11 million. Such a finding would have meant that Cenco's settlement caused them no injury.

The Seventh Circuit's opinion in *Cenco* commits the threshold error of not considering whether the evidence showed that the corporation's net benefits exceeded its losses. Its analysis assumed parity between these two figures. Even if there were parity, this finding would exclude participation by only the oldest group of shareholders. But the court gave no consideration to the circularity that arises when present stockholders are also the beneficiaries of a class-action settlement with their corporation.¹³⁶

134. *Id.* at 459.

135. See *Schacht v. Brown*, 711 F.2d at 1348-49 (a penetrating analysis of the effect of a recovery on the various parties leading to a different result in *Cenco*). See also Note, *Cenco, Inc. v. Seidman & Seidman: A Futile Attempt to Deter Management Fraud*, 1984 DUKE L.J. 141, 152-53 (corporate recovery more effectively deters beneficial fraud than detrimental fraud).

136. The result reached in *Cenco* also appears to conflict with the approach generally taken to determine a corporation's rights against its accountants' failure to detect wrongdoing by the corporation's managers. For example, in *Shapiro v. Glekel*, 380 F. Supp. 1053 (S.D.N.Y. 1974), the court refused to dismiss an action brought by a bankrupt corporation's trustee against accountants who allegedly overstated the company's financial position. The false appearance of profitability enabled the company to carry out several acquisitions that it otherwise would not or could not have undertaken. The *Shapiro* court justified holding the accountants responsible because, in the context of public corporations, accountants are retained for their integrity and expertise

Synthesis

The case law's preoccupation with compensation could subordinate entirely the notion that corporate actions reduce the overall risk attributable to management misbehavior. In fact it appears that because deterrence is overtaken by the suit's compensatory function only in very narrow situations, the vitality of the corporate suit is not seriously eroded by the holdings in *Barber* and *Bangor Punta*. Nevertheless, a disappointing effect of this announced compensatory purpose is its unfortunate tendency to withdraw from view a realizable compensatory effect whenever there has been an ownership change in a significant amount of the corporation's stock, such as occurred in *Lewis*, *Rock River*, and *Cenco*. This criticism, however, is a criticism of the amount of emphasis to be given to the suit's compensatory function, and the point discussed above for *Lewis*, *Rock River*, and *Cenco* is that liability could easily have been premised upon providing compensation had the court more closely examined the parties' positions.

A far more important criticism is whether casting the conflict in terms of a suit's compensatory or deterrent function necessarily disserves both missions. As seen, the conflict between these two functions occurs whenever the court sees that a monetary recovery will redound to the benefit of a party who has not been financially disadvantaged because of the managers' misbehavior. The suit's potential is seen exclusively in terms of its punitive effects upon the defendant. To be sure, in some cases these are the relevant areas of concern. For example, when the sole shareholder's misbehavior harms his corporation, as occurred in *Barber*, there seems little reason why that conduct should be deemed a violation of the corporation's rights or a penalty to its sole owner when the conduct that occurred is justified.¹³⁷ On the other hand, it appears that the notions of compensation and deterrence must each be interpreted expansively in cases such as *Miller* or *Lewis* because their public corporation characteristics introduce several considerations not present in the simpler factual setting of the small corporation harmed by its dominant stockholder. In this context, the suit's prospective impact both on the corporation and on corporate America are areas where value through continued prosecution of the suit can be found, such that with a broader concept of compensation than the absence of a loss, the corporate suit is worthy of

to protect the public investor. *Id.* at 1056-58. The court, however, created an exception for cases involving egregious interference with the accountants' performance. *Id.* at 1058.

137. *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981), however, allowed the corporation's trustee in bankruptcy to recover for losses suffered by the nonfeasance and misfeasance of *all* its stockholders which defrauded its creditors.

continuance.¹³⁸ In this regard, consider that the conduct complained of in *Lewis* was wasteful "golden parachutes," which is a growing public concern arising from the malaise of whether managers act to maximize the value of the firm or their own utilities. It also arose in the very facts of *Lewis* which, under a narrow concept of compensation, make the suits's continuance difficult to establish in terms of serving a compensatory mission. By broadening the scope of inquiry to include the suit's potential impact on the frequency of wasteful golden parachute arrangements, benefits, albeit intangible ones, could have been associated with the suit's continuance. In a similar manner, a suit alleging that the managers committed a knowing violation of a criminal statute or for that matter a standard established by the shareholders, should not escape suit upon mere proof that their conduct produced a profit. Courts should consider as well the benefits of chastening managers either by allowing a modest recovery¹³⁹ or introducing into the corporate structure remedial changes designed to prevent a recurrence where the managers may in the future not be as fortunate to earn a profit through their misdeeds.¹⁴⁰ These suggestions are advanced to illustrate the broader concept that a fuller consideration of the suit's potential impact on the corporation and climate within which it operates as well as its shareholders can reveal that there is no genuine conflict between either compensation or deterrence in a good many cases where courts have justified dismissal of the action.

138. See generally Harbrecht, *The Contemporaneous Ownership Requirement in Shareholders' Derivative Suits*, 25 UCLA L. REV. 1041, 1045 (1978); Note, *Survival of Rights of Action After Corporate Merger*, 78 Mich. L. Rev. 250, 256-58 (1979) (courts have carved out exceptions to the rule of passage that include permitting litigation to continue in the name of the merged party and applying securities laws or general powers of equity to continue the suit). This reasoning appears to lie at the heart of modern statutes which loosen considerably the strict application of the contemporaneous ownership rule. See, e.g., CAL. CORP. CODE § 800(b)(1) (West 1977); PA. STAT. ANN. tit. 15 § 1516 (Purdon 1967) (shareholder or person who is beneficially interested in shares of the corporation will, at the discretion of the court, be allowed to maintain an action if there is a strong prima facie case in support of it and if, without the suit, serious injustice will result).

139. Professor Fischel has eloquently expressed concern for the suit's value when the monetary recovery pales in comparison to the firm's market value: "If the only situation in which market mechanisms do not hold managers fully 'accountable' is the situation in which no significant impact on share prices occurs, why worry?" Fischel, *supra* note 15, at 1288 n.103. Answers to this question can be found on two levels. A purely legal response examines whether requiring managers to disgorge their ill-gotten gains harms the corporation even though this does not enhance the corporation's wealth materially. The reasons for doing so give rise to the second response: the decision to proceed against wrongdoing, regardless of whether the amount is material, yields social benefits by reducing misconduct and hence the cost of capital. See Vagts, *supra* note 36, at 274.

140. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 594-95 (1983) (expressing the view that more meaningful sanctions than damages be considered to assure effective control of managers and their monitors). Professor Cohn also suggests that the problem to date has been not in the articulation of the standard of due care, but rather a failure to impose the standard voiced by the court. *Id.* at 616-24.

IV. *The Proposals to the ALI*

After recognizing the many practical considerations inherent in derivative suits that prevent them from becoming wholly compensatory or inhibit their deterrent effect,¹⁴¹ the procedural proposals to the ALI purportedly compromise between compensation and deterrence.¹⁴² In fact, when purposes conflict, the ALI's proposals almost uniformly prefer deterrence. In the exercise of this choice, the project's reform features become clear because, as the preceding review of compensation in the case law reveals, courts consistently reject deterrence as the basis for procedural rulings in derivative suit litigation. However, the same discussion shows that courts have often misperceived the absence of a compensatory purpose or responded inflexibly to the plaintiff's request that relief fulfill a compensatory function. Therefore, the "true" reform does not occur in those proposals to the ALI that encourage flexibility or that select minority positions accommodating plaintiff's requests for special procedural rulings.¹⁴³ These changes correct prior case law based on the experience of jurisdictions more willing to deviate from the strict requirements of existing procedural rules. On the other hand, chapter VII often pursues the quest for deterrence against the grain of both the compensatory function and case law.¹⁴⁴ This daring journey deserves careful consideration of the costs and benefits posed. Finally, chapter VII contains pervasive characterization problems, much like those inherent in Professor Scott's proposal.¹⁴⁵

A. Encouraging the Judiciary to Exert Itself

Many provisions in the proposal to the ALI remind courts to examine each case closely to assure that the facts contain no potential compensatory function which can be realized by invoking the proposal's flexible remedies provision. In articulating the criteria for initiating derivative suits, the proposal adopts the modern trend that extends standing to a noncontemporaneous shareholder who acquired the shares "prior to the time when the material facts relating to the alleged wrong were publicly disclosed or were otherwise made known to" the shareholder.¹⁴⁶ Also, the proposal departs from the rule of *Lewis v. Anderson*¹⁴⁷ by providing that a disposition of the plaintiff's shares in a corporate transac-

141. CORPORATE GOVERNANCE, *supra* note 2, at 224-27.

142. *Id.* at 232-34.

143. See *infra* notes 146-152 and accompanying text.

144. See *infra* notes 162-165 and accompanying text.

145. See *supra* notes 62-74 and accompanying text.

146. CORPORATE GOVERNANCE, *supra* note 2, § 7.02(a)(1).

147. 477 A.2d 1040 (Del. 1984). See *supra* notes 116-119 and accompanying text.

tion, such as a merger, in which the plaintiff “did not acquiesce” will not terminate the suit.¹⁴⁸ A related provision empowers courts to provide a *pro rata* recovery, analogous to a class-action recovery, to accommodate differing impacts of the wrongdoing on groups of shareholders. Differences could result from an intervening merger or from the naturally shifting composition of stockholders, as illustrated by *Cenco*.¹⁴⁹ Each provision responds to the specific criticisms of the cases in which courts dismissed suits involving difficult compensation issues rather than analyzing the parties’ relative positions and decreeing a *pro rata* recovery. For example, under the proposals to the ALI, the *Lewis* court would not have dismissed the suit because it was pending at the date of merger.¹⁵⁰ Instead, the Delaware court, after finding a breach and consequent harm to the acquired corporation, could have ordered recovery directly to those harmed by the misconduct.¹⁵¹ To decide whether to allow a *pro rata* recovery only to the acquired shareholders, the court would consider whether and in what manner the misconduct of the acquired company’s managers affected the merger price. A similar analysis of the differing positions among Cenco’s shareholders would make recovery more probable because of the express authorization of a *pro rata* remedy under the proposals.¹⁵²

The proposal to the ALI, however, erects its own rigid requirements which conflict with a compensatory function. As mentioned above, plaintiffs lack standing to maintain a derivative suit if they either acquired their shares after becoming aware of the managers’ misconduct,¹⁵³ or commenced the action after being dispossessed of the shares in a corporate transaction, such as a merger.¹⁵⁴ These limitations reflect the view that the plaintiff must be one who was “truly injured”¹⁵⁵ and that legal norms should not encourage the bar to become “bounty hunters.”¹⁵⁶ This Article questions neither proposition, but counsels below that the proposals to the ALI could adopt a more flexible approach to each of these situations without violating either concern.

Because the proposal’s treatment of standing is tightly wedded to the compensatory function, this discussion will examine the proposal exclusively in terms of its fulfillment of this function. Clearly, deterrence justifies a relaxation of standing criteria. Yet

148. CORPORATE GOVERNANCE, *supra* note 2, § 7.02(a)(2).

149. See *supra* note 131 and accompanying text.

150. CORPORATE GOVERNANCE, *supra* note 2, § 7.02(a)(2).

151. See also *Gabhart v. Gabhart*, 267 Ind. 370, 370 N.E.2d 345 (1977) (employing a similar remedy).

152. Cf. *Perlman v. Feldman*, 219 F.2d 173, 178 (2d Cir.) (dominant shareholder who is also principal officer is liable to minority shareholders if he deprives the corporation of the possibility of gain), *cert. denied*, 349 U.S. 952 (1955). For example, in *Cenco*, as in *Perlman*, the court was concerned that the fraudulent managers, who were also Cenco shareholders, would share indirectly in a corporate recovery.

153. CORPORATE GOVERNANCE, *supra* note 2, § 7.02(a)(1).

154. *Id.* § 7.02(a)(2).

155. *Id.* at 255.

156. *Id.*

the proposals, which employ deterrence elsewhere, do not favor deterrence as grounds for standing to bring a derivative suit. In connection with the discussions of the *National Union*, *Lewis*, and *Bangor Punta* decisions, this Article reasoned that the security's price can impound the expected value of the cause of action against managers for their misconduct. If so, then the case becomes not one of unjust enrichment, justifying dismissal as in *Bangor Punta*, but rather one which finds a compensatory function in such an expectation, as in *National Union*.¹⁵⁷ Obviously an expectation of recovery is misplaced in publicly traded firms where an individual's small transaction will probably not affect the market price of the security. Public purchasers, therefore, pay an immaterial amount for the right to proceed against managers. Furthermore, an expectation of future recovery, and therefore payment for that right, is unrealistic in the face of the proposal's strict standing requirement that conditions recovery on a lack of awareness of the action. In this way the proposal becomes a Catch 22 for justifying a compensatory function.

At the same time, the proposal to the ALI, while not addressing the precise question in *Bangor Punta* — because that case technically involved an injured corporation and not a derivative suit — nevertheless embraces *Bangor Punta*'s view that courts should eschew a corporation's recovery if it results in unjust enrichment.¹⁵⁸ Thus, if corporation A's managers obtain golden parachutes prior to A's merger into corporation B, under the reasoning of *Bangor Punta*, corporation B could not recoup these agency costs if it did not consider them while negotiating the merger price. Moreover, corporation A's stockholders could not recover unless the derivative suit against the parachuting managers were pending when the merger occurred.¹⁵⁹ Contrary to the solution urged earlier,¹⁶⁰ the proposals to the ALI respond to a problematic empirical question by advocating dismissal of the action. To be sure, administrative concerns in articulating standing criteria seek to discourage suits of questionable worth and suits involving no injury.¹⁶¹ Nevertheless, where the proposals to the ALI have in other areas so aggressively favored deterrence, their prevention of any inquiry into the compensatory purposes of derivative suits appears overly rigid and highly questionable. It is far better to engraft into the provisions

157. *National Union*, 498 F. Supp. at 1004-05.

158. CORPORATE GOVERNANCE, *supra* note 2, at 236.

159. *Id.* § 7.02(a)(2).

160. See *supra* text following notes 136-139.

161. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742-43 (1975) (standing rules separate plaintiffs who have suffered actual injury from the larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it).

some flexibility by permitting courts to waive the requirements about "earlier awareness" and "later disposition" when satisfied that relief can be structured to avoid unjust enrichment and that shares were not acquired for the principal purpose of initiating a derivative suit.

B. A Dominant Deterrent Objective

In two important areas, the proposal to the ALI makes deterrence paramount over a compensatory objective. First, although defendants can usually avoid liability by establishing that their misconduct created a net benefit to the corporation, the proposal disallows such a defense if the court believes the defense "would frustrate an authoritatively established public policy."¹⁶² Second, courts in their review of a dismissal recommendation of a special litigation committee must find that "dismissal of the action would not frustrate any authoritatively established public policy."¹⁶³ The Reporter cites¹⁶⁴ *Burks v. Lasker*¹⁶⁵ as the source for this limitation.

The case law reviewed above¹⁶⁶ reflects an overall philosophy that derivative suits should not serve solely a deterrent function. *Burks v. Lasker* does not depart from this view, but addresses a narrower concern of congressional intent. *Burks* involved a derivative suit against an investment company's advisor and some of its directors who allegedly violated the Investment Company Act of 1940 and the Investment Advisors Act of 1940.¹⁶⁷ The District Court dismissed the suit in response to a special litigation committee's recommendation.¹⁶⁸ The Supreme Court reinstated the action, holding that courts must determine whether dismissal in response to the directors' recommendation would conflict with the policy embodied in the federal statute which the plaintiff asserts was violated.¹⁶⁹ To illustrate circumstances in which a committee's dismissal recommendation would impermissibly conflict with federal law, the *Burks* court referred¹⁷⁰ to section 36(b) of the Investment Company Act¹⁷¹ and section 16(b) of the Securities Exchange Act.¹⁷² The narrowness of the limitation recognized in

162. CORPORATE GOVERNANCE, *supra* note 2, § 7.16(c). The most recent draft prevents dismissal when it "would . . . frustrate any legal rule that operates for the protection of shareholders." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.08(a)(5) (Council Draft No. 5 1984). This refinement was suggested earlier, *supra* text accompanying note 97. The following criticism serves to underscore the importance of construing the new draft language narrowly.

163. *Id.* § 7.08(a)(3).

164. *Id.* at 327.

165. 441 U.S. 471, 480 (1979). Also credited is *Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981).

166. See *supra* notes 83-117 and accompanying text.

167. *Burks*, 441 U.S. at 471.

168. *Lasker v. Burks*, 426 F. Supp. 844, 853 (S.D.N.Y. 1977).

169. *Burks*, 441 U.S. at 480.

170. *Id.* at 483-84.

171. 15 U.S.C. § 80a-35(b)(1976).

172. *Id.* § 78p(b).

Burks is evident in the Court's recent holding that section 36(b) does not create a corporate action.¹⁷³ Thus, directors have no control whatever over the suit's progress.¹⁷⁴ Section 16(b) also expressly empowers a shareholder to maintain the suit where the directors "refuse to bring such suit."¹⁷⁵ Therefore, while *Burks* may have suggested the limitation adopted in two distinct contexts in the proposals to the ALI, the scope of the proposals exceeds that of *Burks*.

This dissonance between *Burks* and the proposals, however, is not enough to reject the requirement that courts consider whether a defense will "frustrate authoritatively established public policy." In this regard, consider the practical effect of each proposed constraint. Two situations illustrate that effect. If managers defend themselves by contending that the corporation reaped a net gain from the violation of state or federal statutes, the proposal's application introduces a difficult question concerning the appropriate damages. *Tentative Draft No. 1* provided for minimal damages for clear breaches of the directors' duty not to violate established laws knowingly.¹⁷⁶ Therefore, the proposal's effect is to impose a penalty for technical violations of directors' duties such as a duty to conform to state and federal statutory law. In the second situation, a court cannot grant a dismissal in response to a committee's recommendation, regardless of the committee's composition, unless it finds that dismissal will not "frustrate authoritatively established public policy."¹⁷⁷ In this context, the "public policy" standard has quite the opposite effect. The committee, in all cases, must premise its dismissal recommendation upon its understanding of corporate interest, namely that the suit's expected benefits are less than its costs. If a court disagrees with this accounting, that source of disagreement, not its concern for the "frustration of authoritatively established public policy," would warrant rejecting the committee's finding. Therefore, the plaintiff will invoke the policy standard only when the corporation is clearly better off without the suit. In such a case, the corporation's treasury becomes the handmaiden to enforcing federal and state directives. As in the description of the insights of portfolio theory,¹⁷⁸ courts

173. *Daily Income Fund, Inc. v. Fox*, 104 S. Ct. 831, 833, 842 (1984), *affg*, 692 F.2d 250 (2d Cir. 1982).

174. *Id.* at 842.

175. 15 U.S.C. § 78p(b) (1976).

176. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.06 (d)(1) (Tent. Draft No. 1, 1982) [hereinafter referred to as *Tentative Draft No. 1*]. *Tentative Draft No. 1*, § 7.06(d)(1) refers to the general duties of directors in section 4.01, including the obligations of a corporation to stay within the bounds of the law under § 2.01.

177. CORPORATE GOVERNANCE, *supra* note 2, at § 7.08(a)(3).

178. See *supra* text following note 13.

can justify allowing costly suits to proceed because the corporation may nevertheless benefit through a reduction in the overall systematic risk attributable to management misbehavior. This reasoning, however, is difficult to apply where the same legal rules force onto the corporation costs in excess of the probable gains derived directly from the suit. Therefore, rather than reducing systematic risk, the proposals to the ALI contribute an ambiguous new variable to corporate misconduct, namely the uncertainties of what constitutes "authoritatively established public policy."

Yet another, more compelling argument, weighs against the public-policy standard contained in the proposal. The proposals to the ALI seem to assume that deterrence will weaken absent derivative suits linked to violations of "authoritatively established public policy." Stated differently, the proposal assumes that derivative suits will contribute towards the deterrence of socially harmful conduct. Certainly answering that question negatively removes the justification for a public-policy standard because that standard applies when a compensatory function is absent. Scholars have established the linkage between the level of a monetary penalty, the probability of detection, and the incidence of unlawful activity.¹⁷⁹ Increases in either the probability of detection or the size of a penalty affect the frequency of violative behavior, unless the violator is not risk averse. Thus, one might argue that damages imposed in the derivative suit add to the deterrence formula.

Two important considerations, however, weaken this conclusion. It is doubtful whether derivative suits will change the overall incidence of detection and apprehension of unlawful behavior. Generally, private actions alleging that managers engaged in criminal violations occur only after the initiation of a public investigation or prosecution.¹⁸⁰ The bribery, insider-trading, and antitrust-violation cases easily fit this mold. Moreover, courts would probably employ the public policy standard to cases involving *de minimus* damages so that the relatively small, minimal-damage provisions of the proposal to the ALI would apply.¹⁸¹ These minimal amounts, although greater than the harm in fact suffered by the corporation, would not deter managerial misconduct. The Reporter must offer more persuasive evidence or reasoning that the derivative suit, armed with a public-policy standard, will affect materially either the detection or the deterrence of managerial vi-

179. See, e.g., Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 178-79 (1968) (postulating that the number of offenses is a function of, in part, the probability of conviction per offense and the punishment per offense); See generally Darby & Karni, *Free Competition And The Optimal Amount of Fraud*, 16 J. L. & ECON. 67 (1973) (analyzing the real benefit to the market of increasing government mechanisms to detect fraud).

180. See, e.g., Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 16 (1980) (characterizing private enforcement actions as "largely parasitic" to SEC enforcement actions for insider trading).

181. The defendant's ability to establish a net gain through the violation and plaintiff's inability to prove losses or costs related to such wrongful conduct would produce this result.

ulations of state or federal law. Absent such a showing, the invoking of public-policy constraints in dismissing derivative suits where there is no compensatory purpose poorly serves the corporation's interests. What appears more appropriate is for courts to weigh the probable benefits to all corporations through proscribing the challenged conduct and to consider as well whether its proscription and any concomitant deterrence will likely occur in some other proceeding.¹⁸² These considerations are necessary qualifiers to the otherwise open-ended injunction that dismissal not occur if it were deemed to conflict with "authoritatively established public policy."¹⁸³

C. Utilization of a Characterization Test

The proposals to the ALI openly discriminate between duty-of-care cases and duty-of-loyalty cases. However, unlike Professor Scott's conclusions,¹⁸⁴ the ALI continues to impose upon managers a meaningful standard of care, especially when the suit consists of a knowing violation of state or federal law. This discrimination enables a corporation's directors to deflect easily derivative suits involving solely care violations. Correlatively, it becomes much more difficult to dismiss cases involving a fiduciary's receipt of an "improper benefit." The proposal's discrete tinkering with the special litigation committee's burden of proof in each type of case, and in its provision for "fee shifting" achieves these results.

The cornerstone of chapter VII is the pretrial hearing to consider the suit's impact on the corporation's interests. Although the proposal carries forward the demand-on-directors requirement and confines the basis for excusing these demands,¹⁸⁵ later provisions trivialize their operational effect.¹⁸⁶ The Reporters intend that the demand requirement inform the corporation of the suit's basis, thereby providing a means for corrective action and for the corporation to assume control of the suit.¹⁸⁷ Dismissal occurs not through the demand requirement but by a recommenda-

182. *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), employed such an approach in upholding the corporation's right to recover the trading profits of its fiduciaries who sold shares on the basis of confidential information obtained by their employment relationship with the corporation. At the time of its decision, the court believed that there would be little prosecution of corporate personnel for insider trading by either investors or the SEC. *Id.* at 502-03, 248 N.E.2d at 914-15, 301 N.Y.S.2d at 84-85.

183. For evidence that one can determine for almost any legal norm that dismissal would violate authoritatively established public policy see Coffee & Schwartz, *supra* note 71, at 284-300.

184. See *supra* note 62 and accompanying text.

185. CORPORATE GOVERNANCE, *supra* note 2, at § 7.03.

186. *Id.* at 265-67.

187. *Id.* at 268-69.

tion tendered by a committee of directors chosen by the board or other individuals selected by a court.¹⁸⁸ In response to an ever-increasing fear that these committees suffer from a structural bias which makes them incapable of rendering impartial assessments of suits against their colleagues,¹⁸⁹ the proposals require that the committee establish not only that dismissal serves the corporation's interest, but, as seen above,¹⁹⁰ that dismissal will not frustrate authoritatively established public policy.¹⁹¹ In the uncomplicated case of a derivative suit against a corporate fiduciary, a preponderance of the evidence satisfies this burden.¹⁹² However, in derivative suits against a control person, which is broadly defined,¹⁹³ the committee's recommendation must be established by "clear and convincing evidence that the action is without merit or that [the corporation] will suffer material harm because of" the suit's continuance.¹⁹⁴ The preponderance-of-the-evidence test, however, applies if the court selected the panel recommending dismissal.¹⁹⁵

The duty-of-loyalty standard plays a more discrete, but nonetheless important role in a committee's consideration whether the derivative suit poses a net gain or loss to the corporation. Factors relevant to the committee's recommendation include the corporation's litigation costs, amounts needed to indemnify the defendant, and counsel fees. The greater these costs relative to the expected recovery, the easier it is for the committee to recommend dismissal. The proposal to the ALI alters this formula by providing minimum damages for duty-of-loyalty violations. Section 7.16(d) provides that the losses proximately caused for loyalty violations "should include the costs, fees, and expenses paid or incurred by the corporation . . . including any amounts paid in respect of the counsel fees and expenses of the successful plaintiff. . . ."¹⁹⁶

A final provision which turns on the care-loyalty distinction places a maximum limit on damages for care violations. The proposals currently before the ALI have reserved, until February, 1985, further consideration of this subject; *Tentative Draft No. 1*

188. *Id.* §§ 7.08-7.12.

189. See, e.g., Coffee, *Beyond the Shut-Eyed Sentry: Toward A Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1231 (1977); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 111 (1980); Comment, *A Procedural Treatment of Derivative Suit Dismissals by Minority Directors*, 69 CALIF. L. REV. 885, 899-900 (1981); Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 619-22 (1980).

190. See *supra* notes 162-181 and accompanying text.

191. CORPORATE GOVERNANCE, *supra* note 2, § 7.08(a)(3).

192. *Id.* § 7.08(b).

193. *Id.* §§ 1.06, 1.07. See also *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) (four directors who control corporation's management not allowed to appoint committee).

194. CORPORATE GOVERNANCE, *supra* note 2, § 7.09. This higher burden does not apply if the court has appointed the panel to investigate the control person's alleged receipt of an improper benefit. *Id.* § 7.09(b).

195. *Id.*

196. *Id.* § 7.16(d).

conditioned the ceiling upon a court finding that the defendant had not engaged in knowing misconduct or reckless behavior, and had not received improper benefits from the transaction.¹⁹⁷ The ceiling amount adopted in *Tentative Draft No. 1* depended upon whether the defendant was an outside director or an insider.¹⁹⁸

Except for the provisions addressing the special litigation committee's burden of proof, these proposals to limit liability have both *ex ante* and *ex post* effects. Their *ex post* effects are in determining the recoverable amount once a violation has been found and that violation has been characterized in terms of a matter of ordinary negligence or otherwise. But the impact of maximum and minimum liability levels also has *ex ante* effects in the pretrial screening procedure in which a committee is encouraged to predict the suit's effect on the corporation's interests. If the complaint alleges wrongdoing by control persons in which an improper benefit was received, and a committee is not able by clear and convincing evidence to refute the complaint's substance, damages are not only open-ended, but are increased by the corporation's direct and indirect litigation expenses.¹⁹⁹ On the other hand, if the committee successfully refutes the allegation under the clear and convincing test, the impact of the assignment of fees and the arrival of a ceiling on damages are of little import, because a suit of doubtful substance is, by definition, not in the corporation's interests and should be dismissed.

The real impact of these provisions is to avoid dismissal of the loyalty-based case where the breach is conceded, but the committee otherwise could argue that the costs to remedy that breach exceed the probable recovery for such a technical breach. In this case, the assignment of fees becomes the penalty imposed to deter such misbehavior. Efficiency is theoretically introduced, at least vis-a-vis the corporate fisc, by having the costs absorbed by the defendant-wrongdoer.

These provisions have an even more pronounced effect on care cases. When the court is persuaded, either on the face of the pleadings or after its review of a committee's recommendation, that the case does not involve more than a charge of ordinary negligence by the directors, the ceiling on damages will come into play and there will be no assignment of the corporation's litigation expenses to the defendant. This greatly alters the accounting for

197. Tentative Draft No. 1, *supra* note 176, § 7.06(d)(i).

198. For outsiders, the ceiling was \$200,000; for insiders the ceiling was the greater of \$200,000 or twice the defendant's gross compensation. *Id.* § 7.06(e). Council Draft No. 5, § 7.17(b), *supra* note 162, provides ceilings for all defendants in the amount of their firm compensation for the fiscal year of their breach.

199. CORPORATE GOVERNANCE, *supra* note 2, § 7.16(d).

gains and losses from that in the loyalty violation cases making dismissal appear more likely because the accounting for the suit's costs and benefits under the proposal causes the former to exceed the latter so that dismissal appears to be in the corporation's best interests. That is, with the litigation costs assumed to be high coupled with a ceiling on recovery, the continuation of the suit is hardly to be cost effective. Moreover, the committee's view of these costs and benefits will then be judged not by a clear and convincing standard but that of a preponderance of the evidence. The overall effect therefore is that care-based violations are very much disfavored under the procedural requirements of the proposals to the ALI.

The reasons for treating care and loyalty cases differently are not based on the market, as suggested by Professor Scott.²⁰⁰ The commentary to chapter VII suggests, ironically, that the pretrial screening procedures are important to dispose effectively of questionable care cases, so that the proposal's provisions have been drafted to disfavor care cases. The irony arises because the pretrial mechanism for screening derivative suits constitutes a cornerstone of the entire derivative-suit proposal to the ALI.

The Reporter foresees the problem "where very large damages were alleged, even though the plaintiff had, for example, only a ten percent prospect of a favorable judgment."²⁰¹ Thus, if a plaintiff challenged management's defensive maneuvers that successfully thwarted a takeover offering a \$100 million premium, the very magnitude of the amount in controversy would overcome the low probability of a violation, causing a court to allow the suit to proceed. Decisions that do not result in the manager's receipt of an "improper benefit" will probably involve such large amounts. These decisions, however, when questioned under the derivative suit procedures proposed to the ALI, would be dismissed easily, especially with a minimum damage provision.

The differing treatment accorded care and loyalty cases illuminates a weakness at the very foundation of the proposals: the mechanism for pretrial screening of the suit's impact on the corporation's interests. The perceived incapacity to articulate and to apply meaningful review procedures appears to underlie the proposals' distinctions. In fact, the ALI's proposal concedes this point. If the proposal's Reporter trusted the review process for a committee's recommendation, particularly in light of the clear and convincing evidence standard,²⁰² then it seems consistent to permit even the defendants to submit a dismissal recommendation. The present proposal, however, prohibits defendants from issuing their own recommendation. This denial reflects a belief both that defendants cannot evaluate their conduct impartially as well as a concern that inherent limitations plague the review process, sig-

200. See *supra* note 62 and accompanying text.

201. CORPORATE GOVERNANCE, *supra* note 2, at 233-34.

202. *Id.* § 7.09.

nificantly weakening the court's power to unearth structural biases. The Reporter attributes weaknesses to the necessity that pretrial screening procedures be economical, such as by limiting discovery and hearings; these limits necessarily produce an overwhelming informational advantage for the committee, which benefits the defendants.²⁰³ It appears evident from the proposals to the ALI that the solution to these inherent weaknesses was not to develop workable review standards and pretrial hearing procedures, but instead to cast aside suits for care violations.

A final justification for the differing treatment of care and loyalty cases lies in the Reporter's statement "that the historic and most important function of a litigation remedy has been to enforce the duty of loyalty."²⁰⁴ It is beyond dispute that most cases resulting in money judgments or settlements involve some form of self-dealing and that most derivative suits involve allegations of self-interest. Whether an overly protective demand requirement overseen by an overly solicitous judiciary stifled cases and recoveries under the duty of care poses an insolvable empirical question. Similarly, as a straightforward political matter, one may more easily change derivative suit procedures to encourage actions for violations of the duty of loyalty if these changes do not carry ordinary management decisions to the same outcomes.²⁰⁵ Central to this political dynamic is the *ex ante* impact of proposals which systematically disfavor care-based suits in the pretrial stage.

A far more informed approach would take comfort in those provisions of the proposals concerning fee shifting²⁰⁶ so that the defendants and the corporation may recover their litigation costs for unmeritorious actions. This *ex post* response does not involve the time and informational limitations which pervade pretrial screening procedures. In addition, reconsideration of the damages to which the defendants may be subjected is appropriate. When duty-of-care violations cause substantial harm, a ceiling should not limit recovery except under the most exceptional circumstances.²⁰⁷ In this respect, the ceiling proposal serves an unintended purpose. Any breach should subject its perpetrator to liability for the damages proximately caused, including the corporation's litigation costs. However, the proposals should empower courts to make exceptions where the circumstances require. This judicial discretion removes the cloud on possible recovery from

203. *Id.* at 279-80.

204. *Id.* at 221.

205. Scott, *supra* note 39, at 937.

206. CORPORATE GOVERNANCE, *supra* note 2, §§ 7.05, 7.18.

207. A ceiling is an important limitation. Its questioning here is not intended to erode the usefulness of ceilings on care-based violations if there is a legitimate concern that the imposition of disproportionately large damages would deter breaches.

evaluating the suit's worth in the pretrial screening procedure. Actions may then go forward, postponing a decision on limits for a fuller exploration of the facts through truly adversarial proceedings. Furthermore, the proposals should require truly independent litigation committees. The court, not the defendants, must select the committee members,²⁰⁸ who should have backgrounds which assure their independence. So long as the defendants' colleagues control the pretrial screening process, satisfactory review standards will never exist. Under current practices, the courts and plaintiffs have been too easily outgunned and outflanked by the committee's one-sided review of the facts.²⁰⁹

These suggestions are not offered to urge that the law allow more or fewer care cases. They reflect the author's distrust of pretrial characterizations of decidedly complex matters which defy neat division into matters of care and loyalty, and for which an *ex ante* determination will occur before the plaintiff can become as well-acquainted with the facts as the defendant's committee. Disfavoring the duty of care ignores that the duty has, under present law, demanded little of officers and directors. Its function is not that of deterrence, yet this appears to be Professor Scott's fear and the philosophy of the proposals to the ALI.²¹⁰ The law should find violations of the duty of care and impose remedies to compensate shareholders for their losses because of egregious decision making by managers. These cases are as susceptible to derivative-suit procedures as are loyalty cases. Derivative suit procedures should be drafted so that violations of the duty of care can be vindicated as efficiently as violations of the duty of loyalty.

208. *Cf. Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983).

209. *See Cox & Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 *Law & Contemp. Probs.* — (1985).

210. *See, e.g., CORPORATE GOVERNANCE, supra* note 2, §§ 7.08(a)(3), 7.16(c).